

# A Case Study In Income Tax Complexity: The Type A Reorganization

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*You must lie upon the daisies and discourse in novel phrases of your complicated state of mind.* W.S. Gilbert, *Pirates of Penzance* (1879) Act I.

## I. INTRODUCTION

One matter concerning the Internal Revenue Code on which all critics, taxpayers, practitioners, and government officials agree is that the statute is enormously complicated.<sup>1</sup> There is also an abiding optimism that something can be done to simplify it.<sup>2</sup> This Article argues that virtually nothing can be done about the

1. See, e.g., Eustice, *Tax Complexity and the Tax Practitioner*, 8 TAX ADVISER 27 (1977); Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1 (1974); Roberts, Friedman, Ginsburg, Louthan, Lubick, Young, Zeitlin, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972); Surrey, *The Federal Tax Legislative Process*, 31 REC. A.B. CITY N.Y. 515 (1976); Ginsburg, *Tax Simplification—A Practitioner's View*, 26 NAT'L TAX J. 317 (1973); Kurtz, *Tax Simplification: Some Observations from a Retrospective View of the United States Experience*, reprinted in 123 CONG. REC. 16123 (1977); Special Committee on Simplification, Section on Taxation, American Bar Association, *Evaluation of the Proposed Model Comprehensive Income Tax*, 32 TAX LAW 563 (1979).

2. See, e.g., Tax Reform for Fairness, Simplicity, and Economic Growth, The Treasury Department Report to the President, Volume 1—Overview and Volume 2—General Explanation of the Treasury Department Proposals, Prentice Hall Federal Taxes Bulletin 51, Sections 3 and 4, November, 1984; "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity," Prentice Hall Federal Taxes Bulletin 25 Extra May 30, 1985. See generally STAFF OF THE SENATE COMM. ON FINANCE, 99th Cong., 1st Sess., *The Subchapter C Revision Act of 1985*, (Comm. Print No. 47, 1985) [hereinafter cited as *Subchapter C Revision Act of 1985*]. SENATE COMM. ON FINANCE, 98th Cong., 1st Sess., *THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS*, (Comm. Print No. 95, 1983); COMMITTEE ON CORPORATE STOCKHOLDER RELATIONSHIPS, TAX SECTION RECOMMENDATION NO. 1981-5, 34 TAX LAW. 1386 (1981); FEDERAL INCOME TAX PROJECT: SUBCHAPTER C (1982); ABA SECTION OF TAXATION TASK FORCE, *Income Taxation of Corporations Making Distributions with Respect to Their Stock*, 37 TAX LAW. 625 (1984).

complexity of the federal income tax system. The reasons for the complexity are: (1) the several different sources of tax law; (2) the variety and number of transactions that must be covered; (3) the inevitable ingenuity of practitioners in planning transactions around the law; and (4) political pressures placed on the legislative process by special interest groups. These reasons are so deep and far-reaching as to transcend legislative remedy. Policy makers and critics would be well advised to cease their insistent attempts<sup>3</sup> to significantly simplify the system and concede that the system cannot be substantially simplified in the foreseeable future. The recently enacted Tax Reform Act of 1986 amply supports these propositions. Whatever else may be said about the Act, it has hardly simplified the tax system. Indeed, the Act and its legislative history comprise over 1800 pages.<sup>4</sup>

This Article supports these propositions by examining the Type A reorganization. This area of corporate taxation has received considerable legislative, judicial, and administrative attention in the past and is currently, along with the entire field of corporate taxation, the object of major reform proposals.<sup>5</sup> The Internal Revenue Code is the aggregate of several analogous parts. Therefore, to understand the problems underlying a small part of it is to understand the problems underlying all of it. A study of the Type A reorganization develops the reasons for the great complexity of the entire Internal Revenue Code and evinces the insuperable obstacles to major simplification of the American income tax system. This "case study" approach can be more useful in understanding the reasons for complexity than broader generalized discussions.<sup>6</sup>

In discussing the problems with Type A reorganizations, this Article criticizes the recent Supreme Court case of *Paulsen v. Commissioner*.<sup>7</sup> This Article also discusses current proposals for simplification and reform of the Type A reorganization and the other reorganization provisions of the Internal Revenue Code. These proposals have been promulgated by the staff of the Senate Finance Committee, based on the work of the American Law Institute, the Tax Section of the American Bar Association and other professional organizations, and have been formulated into a bill, the Subchapter C Revision Act of 1985.<sup>8</sup> This Article concludes that the proposals incorporated into this bill, if enacted, would not only be ineffective in simplifying the law in this area, but would probably make it more complex.

These provisions for reforming the reorganization provisions were not enacted by the Tax Reform Act of 1986. However, the legislative history instructs the Treasury Department to study the possibility of reform of the corporate tax rules.<sup>9</sup> Presumably, the Treasury Department will use the Subchapter C Revision Act as a point of departure in undertaking its own study.

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3. See *supra* note 2.

4. CONFERENCE REPORT TO ACCOMPANY H.R. 3838, Vols. I & II, Report No. 99-841, 99th Cong., 2d Sess. (hereinafter cited as CONFERENCE REPORT).

5. See *supra* note 2. See also *infra* text accompanying notes 246-74.

6. Cf. *supra* note 1.

7. 469 U.S. 131 (1985). See also *infra* text accompanying notes 53-77.

8. See Subchapter C Revision Act of 1985, *supra* note 2. See also *infra* text accompanying notes 246-74.

9. CONFERENCE REPORT, *supra* note 4, at 207.

## II. THE ROLE OF THE TYPE A REORGANIZATION IN THE TAX SYSTEM

A general principle of the American income tax system is that gains or losses on property held by taxpayers are not taxed or deducted until those gains or losses have been "realized."<sup>10</sup> The property must have undergone a transaction, generally a sale or other disposition, which triggers tax consequences.<sup>11</sup> Even though a gain or loss has been realized, it still might not be recognized if it is one of the relatively small group of transactions that is covered by a nonrecognition rule.<sup>12</sup> Nonrecognition usually involves deferral of the realized gain or loss until some later date, with the unrecognized gain or loss preserved by adjustments to the basis of property held by the taxpayer.<sup>13</sup>

An important class of nonrecognition transactions are the corporate reorganization rules. Generally, these rules provide for the nonrecognition of gain or loss from the sale or exchange of corporate stock or property for corporate transactions which meet the definition of a "reorganization."<sup>14</sup> In this statutory scheme, the definition of what constitutes a reorganization is critical. Only if a transaction meets the definition of a "reorganization" will the attendant nonrecognition rules apply.<sup>15</sup>

Seven types of reorganizations are defined in section 368(a)(1).<sup>16</sup> These types of reorganization derive their names from the subsection of section 368 which defines them. Thus, the Type A reorganization is so named because it is defined in section 368(a)(1)(A).<sup>17</sup>

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10. I.R.C. §§ 1001, 61(a)(3), 62(4) (1986). Unless otherwise indicated, all statutory citations are to the Internal Revenue Code of 1954, as amended.

11. See *supra* note 10. These sections condition taxation upon the occurrence of a realization event, not a mere change in the value of held property. See also *Eisner v. Macomber*, 252 U.S. 189 (1920) (pro rata stock dividend not taxable to shareholders because no income was realized); D. POSIN, *FEDERAL INCOME TAXATION OF INDIVIDUALS AND BASIC CONCEPTS IN THE TAXATION OF ALL ENTITIES*, 148-53 (1983).

There are a few instances when the realization requirement is suspended. Section 951 provides for the taxation of undistributed income of controlled Foreign Corporations. I.R.C. § 951 (1986). Also, section 1256 treats commodity futures held by the taxpayer as if they had been sold for their fair market value on the last day of the taxable year (the so-called "mark to market" rule) to foreclose tax straddles.

12. A presumption exists that a realized gain or loss will be recognized unless a specific nonrecognition provision exempts it. I.R.C. § 1001(c) (1986).

13. See, e.g., I.R.C. § 1031 (complete or partial nonrecognition of gain or loss on certain like-kind exchanges of property); § 1033 (complete or partial nonrecognition on involuntary conversions of property); § 1034 (complete or partial nonrecognition of gain on sale of principal residence). See also D. POSIN, *supra* note 11, at 169-97.

14. See, e.g., § 368 (defining a reorganization); § 361 (providing rules for the treatment of a target corporation in a reorganization); §§ 354 and 356 (providing rules for treatment of the shareholders of the target corporation in a reorganization); § 358 (providing basis rules for preserving unrecognized gain or loss for stock, securities, and other property received by the shareholders of the target corporation in a reorganization); § 362 (providing basis rules for property acquired by the acquiring corporation in a reorganization).

15. See *supra* note 14.

16. I.R.C. § 368(a)(1) (1986).

17. I.R.C. § 368(a)(1)(A) (1986). The other types of reorganization are the Type B reorganization, an acquisition of the stock of the target corporation in exchange for stock of the acquiring corporation, thereby keeping the target corporation alive as a controlled subsidiary of the acquiring corporation; the Type C reorganization, an acquisition of the assets of the target corporation in exchange for stock of the acquiring corporation, the target then distributing the stock of the acquiring corporation to its shareholders as it liquidates; the Type D reorganization, a transfer of assets from one corporation to another corporation which is controlled by the transferor and/or its shareholders followed by a distribution of the stock of the transferee; the Type E reorganization, a recapitalization or reshuffling of the corporate structure of one corporation; the Type F reorganization, a change in the identity, form, or place of organization of one corporation; the Type G reorganization, a transfer by a corporation of all or part of its assets to another corporation in a Title 11 bankruptcy

## III. BASIC ISSUES IN THE A REORGANIZATION

The Type A reorganization is defined in section 368(a)(1) as simply "a statutory merger or consolidation."<sup>18</sup> To qualify as a "statutory merger or consolidation," the transaction must qualify as such pursuant to the laws of a state, the District of Columbia, or a territory of the United States.<sup>19</sup> Since the overwhelming majority of corporations are organized under the laws of the states, most statutory mergers or consolidations are concerned with qualifying under the laws of a particular state. Since the laws vary from state to state, section 368(a)(1) recognizes that transactions will be meeting different requirements to qualify.<sup>20</sup>

The Regulations<sup>21</sup> and the case law interpreting section 368(a)(1) impose additional broad and detailed requirements on the Type A reorganization. Thus, the great simplicity of the statutory language is engulfed by these other requirements. The complete set of requirements for qualifying as an A reorganization are:

1. There must be a statutory merger or consolidation under state law,<sup>22</sup>
2. There must be a "plan" of reorganization,<sup>23</sup>
3. The continuity of interest requirement must be met,<sup>24</sup>
4. There must be continuity of the business enterprise,<sup>25</sup>
5. There must be a business purpose for the transaction,<sup>26</sup> and
6. The step transaction doctrine cannot be applicable to deny a transaction Type A reorganization status even though the transaction satisfies the other requirements.<sup>27</sup>

Given the great breadth and detail of these requirements, it appears that the law defining the Type A reorganization has expanded beyond the control and contemplation of Congress. This situation seems to be inevitable, however, given the roles

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or similar proceeding, if the stock or securities of the transferee are distributed to the shareholders of the transferee. I.R.C. § 368(a)(1)(A)-(G) (1986).

In addition to these types of reorganization, the statute specifies two other versions of the A reorganization. These are: (1) The "forward triangular" A reorganization (I.R.C. § 368(a)(2)(D) (1986)), in which stock of the controlling parent of the acquiring corporation is used as consideration to the shareholders of the target corporation and; (2) the "reverse triangular" A reorganization (I.R.C. § 368(a)(2)(E) (1986)), in which a controlled subsidiary of the acquiring corporation merges into the target corporation in a transaction in which the shareholders of the target corporation receive stock of the acquiring corporation and the acquiring corporation eventually controls the target corporation. Since the two triangular A reorganizations have different requirements from the other reorganizations, they might be considered as separate types of reorganization altogether, bringing the total number of types to nine.

Generally, the A, B, C, and the two triangular A reorganizations are acquisitive in nature because they involve the combination of unrelated corporations. These five types would be compared to a cash transaction in which tax is paid in full and the transferred property is given a cost basis.

18. I.R.C. § 368(a)(1)(A) (1986).

19. Treas. Reg. § 1.368-2(b)(1) (1986). See also *Russell v. Commissioner*, 40 T.C. 810, 822 (1963), *aff'd per curiam*, 345 F.2d 534 (5th Cir. 1965). If the exchange fails to qualify under state law, it might still qualify as a Type C or D reorganization. See Treas. Reg. 1.368-2(b) (1986); Rev. Rul., 57-465, 1957-2 C.B. 250.

20. See, e.g., DEL. CODE ANN. Tit. 8 § 251 (1974); CAL. CORP. CODE §§ 1100-1112, 1201 (West 1977 & Supp. 1986); N.Y. BUS. CORP. LAW § 901 (West 1986).

21. Treas. Reg. §§ 1.368-1, 1.368-2 (1986).

22. See *supra* text accompanying note 19.

23. See *infra* notes 28-32 and accompanying text.

24. See *infra* notes 37-46 and accompanying text.

25. See *infra* notes 86-152 and accompanying text.

26. See *infra* notes 153-91 and accompanying text.

27. See *infra* notes 192-243 and accompanying text.

played by the legislature, the Internal Revenue Service (IRS) and the courts in developing our system of tax law.

#### IV. THE REQUIREMENT OF A "PLAN" OF REORGANIZATION

##### A. Background

Type A or other types of reorganization cannot, according to the statute and the regulations, happen by accident. The taxpayer may not view a series of steps *post facto* and isolate several of them to assert that a reorganization has taken place. There must be a plan.<sup>28</sup> A "plan of reorganization" is defined as having reference to a "consummated transaction specifically defined as a reorganization under section 368(a)."<sup>29</sup> The term "plan of reorganization" should not, according to the Regulations, be construed as broadening the definition of "reorganization" as set forth in section 368(a), but rather as limiting nonrecognition of gain or loss to transactions that are directly part of the transactions specifically described as "reorganizations" in section 368(a).<sup>30</sup>

The plan of reorganization must be adopted by each of the corporations participating in the reorganization. Furthermore, adoption must be shown by the acts of the corporations' duly constituted responsible officers and must appear on the official records of the corporation.<sup>31</sup> Finally, each corporate party to the reorganization must file a complete statement of all facts pertinent to the nonrecognition of gain or loss in the reorganization, including a copy of the plan of reorganization, as part of its tax return.<sup>32</sup>

##### B. Relationship to Step Transaction Doctrine

The requirement of a plan of reorganization resembles the step transaction doctrine.<sup>33</sup> In determining whether several steps shall be combined to ascertain the tax consequences of a transaction, a major issue is what was contemplated by the parties at the time the transaction was commenced. The plan of reorganization adopted by the parties is highly probative on this matter.

This point was confirmed by the Supreme Court in *Commissioner v. Gordon*,<sup>34</sup> which held that the requirement of a distribution of eighty percent or more of the stock of a subsidiary to achieve tax-free treatment to shareholders under section 355 was not met by a distribution in two separate steps separated by two years, in the absence of an unequivocal statement in the plan of reorganization setting forth a binding commitment to take the second step. Conversely, presumably a clear

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28. I.R.C. §§ 354(a) and 361(a) (1986).

29. Treas. Reg. § 1.368-2(g) (1986).

30. *Id.*

31. Treas. Reg. § 1.368-3(a) (1986).

32. Treas. Reg. § 1.368-3(a)(1) (1986).

33. See *infra* notes 191-229 and accompanying text.

34. 391 U.S. 83 (1968).

statement in a plan of reorganization that the steps will be taken would ensure that the steps would be amalgamated.

### C. Not Invoked Against IRS

An observer might have thought that the requirement of a plan would also apply to the IRS when it asserts that a reorganization has taken place and the taxpayer claims there was no reorganization.<sup>35</sup> However, the requirement of a plan apparently is not applicable to the IRS. Even if a plan is not present, the IRS can assert that a series of steps can be integrated to form a reorganization.<sup>36</sup>

### D. Critique

Thus, the requirement of a plan of reorganization adds a significant additional test to the simple statutory definition of a Type A reorganization. However, this requirement appears reasonable. Taxpayers must decide in advance if they want a series of contemplated steps to be treated as a tax-free reorganization. Taxpayers should not be able to decide *post facto*, after the tax consequences are known, whether or not the steps taken should be amalgamated to constitute a tax-free transaction.

## V. THE REQUIREMENT OF CONTINUITY OF INTEREST

### A. Background

The statute imposes no requirements as to the type of consideration that must be received by the stockholders of the target corporation in a Type A reorganization.<sup>37</sup> However, in an agonizing process of judicial law-making (which apparently is not yet completed),<sup>38</sup> the Supreme Court has developed standards for what must be received as consideration by the shareholders of the target corporation in a Type A reorganization.<sup>39</sup>

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35. See *infra* text accompanying notes 193–229.

36. See *Simon v. Commissioner*, 644 F.2d 339 (5th Cir. 1981) (transfer of operating assets and subsequent liquidation of corporation treated as a reorganization when transferee was owned by same shareholders as transferor); *Viereck v. United States*, 3 Cl. Ct. 745 (1983). See also Manning, *In Pursuance of the Plan of Reorganization: The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 HARV. L. REV. 881 (1959).

37. I.R.C. § 368(a)(1)(A) (1986).

38. See *infra* text accompanying notes 53–84.

39. The acquisitive types of reorganizations are the Type A, Type B, Type C, forward triangular A and reverse triangular A. See *supra* notes 14, 16. In the Type B reorganization the statute requires solely voting stock as consideration to the shareholders of the target. I.R.C. § 368(a)(1)(B) (1986). In the Type C reorganization the statute requires voting stock as consideration for the shareholders of the target. In ascertaining whether this test is met, the assumption of the target's liabilities by the acquiring corporation is disregarded. I.R.C. § 368(a)(1)(C) (1986). Moreover, this solely for voting stock requirement is relaxed to the extent that up to 20% of the consideration may be cash. I.R.C. § 368(a)(2)(B) (1986). If cash is used, however, then assumption of the target's liabilities is also considered to be cash for purposes of this 20% rule. I.R.C. § 368(a)(2)(B) (1986). In the forward triangular Type A reorganization the statute requires that no stock of the acquiring corporation itself may be used (only stock of the controlling parent). I.R.C. § 368(a)(2)(D) (1986). In the reverse triangular Type A reorganization the statute requires that at least 80% of the consideration be voting stock of the controlling parent. I.R.C. § 368(a)(2)(E) (1986).

These standards originated in *Pinellas Ice & Cold Storage Co. v. Commissioner*,<sup>40</sup> which held that a sale of corporate assets to another corporation for cash and short-term notes should be taxed even though the transaction met the letter, but not the intent of the reorganization statute of the time.<sup>41</sup> This judicial test came to be known as the "continuity of interest" requirement.<sup>42</sup> Several years after *Pinellas*, the Supreme Court explained that only the receipt of stock satisfied the test, although consideration other than stock could be received.<sup>43</sup> According to these early cases, at least thirty-eight percent of the consideration had to be stock or preferred stock.<sup>44</sup> Recent circuit court cases have not materially altered this standard.<sup>45</sup> The IRS, however, takes a more stringent view, holding that it will not rule favorably on Type A reorganization unless at least fifty percent of the consideration is equity.<sup>46</sup> Thus, this somewhat aggressive reading of the statute by the *Pinellas* Court led to further problems and complexity.

### B. Receipt of Cash by Some Stockholders

Once the requisite amount of equity consideration is received in the transaction, the question arises as to how it must be apportioned among the stockholders. What would happen, for example, if the target corporation had two fifty percent stockholders, one receiving entirely cash and the other receiving entirely stock? Although this would meet the overall continuity of interest requirement, would it still disqualify the transaction?

The IRS answered that question in Revenue Ruling 66-224,<sup>47</sup> holding that the continuity of interest requirement is satisfied if there is adequate equity in the transaction, regardless of how it is apportioned among the stockholders. This Ruling, however, was limited to determining if the overall transaction qualified as a Type A reorganization. Clearly, those shareholders who receive cash will have to recognize gain.<sup>48</sup> Thus, the major importance of this Ruling is for those shareholders receiving stock. The transaction can still be nontaxable to them even though other shareholders receive entirely cash.

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40. 287 U.S. 462 (1933).

41. *Id.* at 469-70.

42. *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932).

43. *Minnesota Tea v. Helvering*, 296 U.S. 378 (1935) (consideration consisting of 55.85% stock and the balance cash satisfied the continuity of interest requirement); *Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (consideration consisting of 38.46% preferred stock and the balance cash satisfied the continuity of interest requirement); *LeTulle v. Scofield*, 308 U.S. 415 (1940) (receipt of bonds as consideration did not satisfy the continuity of interest requirement).

44. See cases cited *supra* note 43.

45. See *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951) (consideration less than 1% equity is not enough); *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936) (25% was enough); *Yoc Heating Corp.*, 61 T.C. 168 (1973) (15% was not enough).

46. Rev. Proc. 77-37, 1977-2 C.B. 568, 569.

47. Rev. Rul. 66-224, 1966-2 C.B. 114.

48. I.R.C. §§ 354(a)(2), 356 (1986).



*C. Debt for Stock: Roebling v. Commissioner*

The great importance of the demarcation between equity and debt in determining if continuity of interest is present in a transaction was vividly demonstrated in the leading case of *Roebling v. Commissioner*.<sup>49</sup> This case involved the exchange of stock for debt by a taxpayer.

In *Roebling*, the taxpayer owned common stock in South Jersey Gas, Electric and Traction Company (South Jersey), which had leased all of its franchises, plant and operating equipment on a net basis for 900 years to Public Service Electric and Gas Company (Public Service). The rentals, net of expenses, received by South Jersey were distributed to its shareholders, constituting a return of eight percent per year on the par value of South Jersey's stock. For various business reasons, South Jersey merged into Public Service, with the shareholders of South Jersey receiving eight percent 100-year, first mortgage bonds of Public Service in exchange for their stock.

The court held that the taxpayer, as a stockholder in South Jersey, had a proprietary interest in South Jersey prior to the merger. After the merger, the taxpayer, as a bondholder in the reorganized companies, did not have a continuity of interest under the rule of *LeTulle v. Scofield*<sup>50</sup> that a continuity of interest requires an equity investment.<sup>51</sup>

Based on the particular facts of *Roebling*, the taxpayer's investment changed little if at all. Prior to the merger, the taxpayer had a virtually guaranteed eight percent return from leases of the operating assets of South Jersey. After the merger, the taxpayer had an eight percent return from first mortgage bonds secured by the same property. However, the court had little difficulty concluding that continuity of interest was not present and the transaction was taxable to the taxpayer.

Cases like *Roebling* simply stimulate further sophisticated taxpayer planning. For example, what should be done on facts similar to *Roebling* today? Apparently, the taxpayer should be given non-voting preferred stock, perhaps with a slightly greater return to compensate for the slightly greater risk. The use of non-voting preferred stock would closely approximate the results of the use of debt and would insure non-taxability of the transaction.

While a case like *Roebling* seems to be unfavorable to taxpayers, it should be remembered that taxpayers do not always wish to consummate a tax-free transaction. Suppose, for example, that a taxpayer in a *Roebling* setting had an unrealized loss on his stock prior to the merger. Intentionally structuring the transaction as in *Roebling* would ensure that the transaction was taxable so the taxpayer could deduct his loss. Similarly, the acquiring corporation in a taxable transaction receives a stepped-up basis in the acquired assets for purposes of depreciation.<sup>52</sup>

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49. 143 F.2d 810 (3d Cir.), cert. denied, 323 U.S. 773 (1944).

50. 308 U.S. 415 (1940).

51. *Id.* at 416-19.

52. I.R.C. §§ 167, 168, 1011 (1986). See also D. POSIN, *supra* note 11, at 309-18.

Thus, every time the IRS wins a case, new planning opportunities are presented for taxpayers and their advisors. This leads to further litigation and possibly additional legislation, and ultimately to more complexity.

D. *Hybrid Securities: Paulsen v. Commissioner*

Application of the continuity of interest doctrine to Type A reorganizations was given a possibly very significant jolt by the 1985 Supreme Court case of *Paulsen v. Commissioner*.<sup>53</sup> Whatever criticisms might be voiced regarding the continuity of interest test, it at least provided a reasonably predictable result. Under the test as defined in *Roebeling*,<sup>54</sup> equity provides continuity of interest, but debt does not. That predictability, however, may have been undermined by *Paulsen*.

*Paulsen* is the first Supreme Court case concerning continuity of interest in several decades. The approach of the majority and the dissent mark a fundamental departure from the analysis historically used in the continuity of interest area. Thus, the majority opinion in *Paulsen* may provide authority for new IRS approaches in scrutinizing Type A reorganizations, particularly when hybrid securities are involved. The dissenting opinion shows lines of defense to this attack.

*Paulsen* involved the merger of a state-chartered stock savings and loan association into a federally chartered mutual savings and loan association. As a result of the transaction, Paulsen surrendered his stock in the state association and received shares in the federal association in exchange. The federal association shares were divided into passbook savings accounts and time certificates of deposit. By law, the federal association could not issue equity. Paulsen had a realized gain of approximately \$153,000 on the transaction, which was not reported as income on the grounds that the transaction was a tax-free Type A reorganization.<sup>55</sup>

The Supreme Court found that the transaction was indeed a statutory merger. However, the Court held that the transaction was taxable to Paulsen because the continuity of interest test was not satisfied.<sup>56</sup>

At one level, this holding is understandable because the federal association did not give any equity as consideration. However, since the federal association was prohibited by law from issuing equity, it attempted to give a substituted form of equity, namely shares of passbook savings accounts and time certificates of deposit. Previously, courts considering the merger of savings and loans had held that this arrangement satisfied the continuity of interest test.<sup>57</sup>

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53. 469 U.S. 131 (1985).

54. *Roebeling v. Commissioner*, 143 F.2d 810 (3d Cir.), cert. denied, 323 U.S. 773 (1944). See *supra* text accompanying notes 49-52. See also *LeTulle v. Scofield*, 308 U.S. 415 (1940).

55. *Paulsen v. Commissioner*, 469 U.S. 131, 135 (1985).

56. *Id.* at 142.

57. See *Capital Savings and Loan Ass'n v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Ass'n v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971). See also Soukup, *The Continuity-of-Proprietary-Interest Doctrine and Thrift Institution Mergers*, 12 J. CORP. TAX'N 141-74 (1985).

The Court's rationale for its decision may have a great impact on the continuity of interest doctrine. The Court, speaking through Justice Rehnquist, undertook a fragmented analysis of the savings accounts and certificates of deposit.

The Court held that the federal association shares were hybrid securities, containing both equity and debt characteristics. This was in sharp contrast to the "all-or-nothing" approach of evaluating consideration that had historically been used in the continuity of interest area.<sup>58</sup>

The decision reflected a very technical comparative analysis of the equity debt characteristics of the savings accounts and certificates of deposit. Each share carried the following equity characteristics: A part ownership interest in the assets of the federal association, in addition to its deposit value; the right to vote on important management issues; a right to receive dividends rather than interest paid out of net earnings; no legal right to a fixed return on the investment; and a right to a pro rata distribution of remaining assets after a dissolution.<sup>59</sup>

In the Court's view, these equity characteristics were "not as substantial as they appear on the surface."<sup>60</sup> The ownership interest was not concentrated, but rather was "spread over all of the depositors."<sup>61</sup> Therefore, the equity interest of each shareholder in relation to the total value of the share is much smaller than in a stock association.

The right to vote, the Court held, also was not significant for several reasons. A shareholder was limited to 400 votes; therefore, any funds deposited in excess of \$40,000 did not confer the right to additional votes. Moreover, since each borrower was entitled to vote, the right to vote was further diluted each time a loan was made. In addition, depositors had generally signed proxies giving management the right to vote their share.<sup>62</sup>

The Court also denigrated the equity aspect of the right to receive dividends by noting that the federal association paid a fixed, preannounced dividend rate on all accounts. Moreover, the accounts were insured by the Federal Savings and Loan Insurance Corporation. In addition, the tax laws treat the dividend as interest on bank accounts rather than as dividends on stock. The dividends were deductible to the federal association and did not qualify for the dividend exclusion under section 116.<sup>63</sup> The Court also viewed the right to participate upon liquidation as insignificant because the likelihood of a liquidation of a solvent savings and loan association was remote.<sup>64</sup>

In contrast, the Court viewed the debt characteristics of the federal association shares as substantial. The passbook accounts and certificates of deposit were not subordinated to the claims of outside creditors. The deposits were not considered permanent contributions to capital, but could be withdrawn on thirty days notice

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58. *Paulsen v. Commissioner*, 469 U.S. 131, 144 (1985) (O'Connor, J., dissenting).

59. *Paulsen v. Commissioner*, 469 U.S. 131, 138 (1985).

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.* at 139.

64. *Id.*

(although Paulsen was required to leave his funds in the federal association for one year following the merger).<sup>65</sup>

The Court also asserted that the face amount of the passbook accounts and certificates of deposit was \$210,000 and that no one would pay more than that for Paulsen's shares. Thus, the value of the equity characteristics of the shares was effectively zero, certainly far less than the substantial amounts of equity required in *Minnesota Tea and Nelson*.<sup>66</sup> Based on this analysis, the Court concluded that continuity of interest was absent in the passbook accounts and the certificates of deposit received by Paulsen.<sup>67</sup>

Justice O'Connor, dissenting in an opinion joined by Chief Justice Burger, also used the fragmentation approach of the majority, rather than the historical "all-or-nothing approach."<sup>68</sup> She agreed that the shares in the federal association were hybrid securities with debt and equity characteristics. However, she argued that the substantial equity characteristics of the shares satisfied the continuity of interest requirement.<sup>69</sup>

O'Connor argued that in exchange for his stock in the state savings and loan, Paulsen had become an equitable owner of the federal association, retaining all the usual rights of corporate stockholders.<sup>70</sup> This interest, according to O'Connor, was more substantial than the interest obtained by the non-voting preferred stockholders in *Nelson*.<sup>71</sup>

O'Connor also noted that no court had ever used the fragmentation method of separately evaluating the debt and equity characteristics of the shares. O'Connor, however, conceded that Revenue Ruling 69-265<sup>72</sup> did support the idea of separating an instrument into its debt and equity components.

In addition, O'Connor disputed the majority's valuation of the equity characteristics of the federal association's shares. In an effort to diminish the majority's assertion that the voting rights of the ownership interests were "spread over all of the depositors," O'Connor explained that dilution of voting power of shareholder equity may occur in any corporation whenever there is a new issue or a new class of stock.<sup>73</sup> She was also unpersuaded by the majority's argument that the shares of the federal association were usually voted by proxy, noting that proxy voting is characteristic of stockholder voting in large corporations. O'Connor also noted that nonvoting

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65. *Id.*

66. *Id.* at 140. See also *supra* notes 37-46 and accompanying text.

67. Paulsen also advanced several other arguments relating only to savings and loan associations and to interpretation of the term "security" for purposes of the federal securities laws. Justice Rehnquist dismissed these arguments. *Paulsen v. Commissioner*, 469 U.S. 131, 140 (1985).

68. *Paulsen v. Commissioner*, 469 U.S. 131, 144 (1985) (O'Connor, J., dissenting).

69. *Id.* at 146-47.

70. *Paulsen v. Commissioner*, 469 U.S. 131 (1985).

71. *Id.* See also *supra* notes 37-46 and accompanying text.

72. Rev. Rul. 69-265, 1969-1 C.B. 109. This ruling concerned a C reorganization in which stock that was given as consideration was convertible into stock of another corporation. The ruling posited certain circumstances in which the convertibility feature would be considered as separate "other" property, thereby invalidating the C reorganization.

73. *Paulsen v. Commissioner*, 469 U.S. 131, 149 (1985) (O'Connor, J., dissenting).

preferred stock was found to confer continuity of interest in the *Nelson* analysis of the sharing of profits.<sup>74</sup>

O'Connor also disagreed with the majority's analysis of the sharing of profits. She noted that the dividends of many large corporations are announced in advance at a fixed rate.<sup>75</sup> Furthermore, she argued that deductibility of the dividends for tax purposes is unrelated to the treatment of the shares of a mutual association as equity.<sup>76</sup>

On the question of the right to participate in the proceeds of a solvent liquidation, O'Connor stated that the market value of that right was irrelevant to the classification of the mutual shares. Furthermore, the likelihood of such a liquidation occurring was similarly not relevant to the classification of the share.<sup>77</sup>

O'Connor concluded her dissent by returning to the question of the fragmentation approach as compared to the "all-or-nothing approach." She suggested that the majority's opinion has ramifications beyond mutual associations.<sup>78</sup> This was the first case in which the Court had the opportunity to consider the use of hybrid instruments in reorganizations. Previously, the Court had decided continuity of interest questions simply on the basis of whether the consideration received was stock. O'Connor believed that predictability of results will be lost if the Court now examines the actual exercise of the rights conferred by ownership of a particular security.<sup>79</sup> O'Connor asserted that if the instrument has the principal characteristics of equity ownership, it should be treated as equity for continuity of interest purposes.<sup>80</sup>

As O'Connor noted in her dissent, the ramifications of *Paulsen* reach far beyond the particular facts of the merger of savings and loan associations. Sophisticated hybrid securities are being widely used in connection with friendly and hostile mergers and acquisitions and going private transactions.<sup>81</sup> These transactions usually are carefully planned. Many of these transactions are intended to be taxable, while others are planned to be tax-free. The IRS may attempt to use the fragmentation approach of *Paulsen* to recharacterize some of these sophisticated instruments to produce adverse tax results for the parties.

For example, a common device in hostile take-over has been the use of subordinated, high-yield, possibly convertible "junk bonds."<sup>82</sup> As part of the transaction, the acquiring corporation may anticipate obtaining a substantially

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74. *Id.*

75. *Id.*

76. *Id.* at 149-50 (citing Note, *Reorganization Treatment of Acquisitions of Stock Savings and Loan Institutions by Mutual Savings and Loan Institutions*, 52 *FORDHAM L. REV.* 1282 (1984)).

77. *Paulsen v. Commissioner*, 469 U.S. 131, 150 (1985) (O'Connor, J., dissenting). The opinion also noted that the conclusion reached by the majority is inconsistent with the tax-deferred treatment accorded mergers between mutual associations or between a stock association and a mutual association when the stock association is the survivor. *Id.* (citing Rev. Rul. 69-3, 1969-1 C.B. 103 (merger of two mutual associations); Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of two mutual associations into a stock association)).

78. *Paulsen v. Commissioner*, 469 U.S. 131, 149 (1985) (O'Connor, J., dissenting).

79. *Id.* at 152.

80. *Id.*

81. See, e.g., STAFF OF THE JOINT COMMITTEE ON TAXATION, *FEDERAL INCOME TAX ASPECTS OF HOSTILE TAKEOVERS AND OTHER CORPORATE MERGERS AND ACQUISITIONS* (Joint Comm. Print, April 24, 1985) [hereinafter cited as *HOSTILE TAKEOVERS*].

82. *Id.*

stepped-up basis<sup>83</sup> in the assets of the target corporation for future depreciation purposes. The IRS might, however, under the aegis of *Paulsen*, determine that these junk bonds have more equity characteristics (*e.g.*, subordination, high or contingent yields, convertibility) than debt characteristics and recharacterize them as equity. This could lead to the transaction qualifying as a Type A reorganization, resulting in nontaxability to the target corporation's shareholders and a carryover basis in the target's assets to the acquiring corporation, contrary to the expectations and preferences of the parties.

Similarly, when preferred stock is used as part of a package of securities which includes senior and junior debt and nonvoting preferred stock,<sup>84</sup> the IRS may determine that the preferred stock has more debt characteristics (*e.g.*, senior to the common stock in dividends and on liquidation, fixed return paid, no voting rights) than equity characteristics. The IRS could then recharacterize this preferred stock as debt, thus disqualifying the transaction from Type A reorganization treatment. This would result in taxation of the target's shareholders and a cost basis in the target's assets in the hands of the acquiring corporation,<sup>85</sup> contrary to the expectations and preferences of the parties.

The implications of *Paulsen* for the administration of the tax laws are unsettling. The law in this area has been made much more complex. *Paulsen* may make it easier for the IRS to recharacterize instruments as debt or equity to defeat or create continuity of interest. Therefore, *Paulsen* may result in conservative practitioners avoiding hybrid securities. The conservative practitioner will want to avoid debt with equity characteristics (subordination, high interest rate, high resultant debt-equity ratio) as well as equity with debt characteristics (nonvoting, held pro rata with other instruments, preferences over other equity). Avoidance of these instruments would prevent the IRS from using the *Paulsen* fragmentation approach to recharacterize these instruments for continuity of interest purposes in a way that might result in tax results contrary to clients' expectations. Thus, general practice in this area may become more complex and unpredictable as a result of *Paulsen*.

## VI. THE REQUIREMENT OF CONTINUITY OF THE BUSINESS ENTERPRISE

### A. Historical Development

In addition to these continuity of interest standards established by the courts and the IRS, the regulations require that continuity of the business enterprise exist for a transaction to qualify as a Type A reorganization.<sup>86</sup> Although the continuity of business enterprise doctrine has not attracted as much attention as the continuity of interest requirement, the continuity of business enterprise requirement may be a slumbering giant that is just now beginning to waken.

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83. For the basis implications of a tax-free reorganization, see I.R.C. §§ 1011, 358, and 362 (1986).

84. HOSTILE TAKEOVERS, *supra* note 81, *passim*.

85. I.R.C. §§ 362, 1012 (1986).

86. Treas. Reg. § 1.368-1(d) (1986) (continuity of business enterprise requirements applicable to all types of acquisitive reorganizations occurring after January 30, 1981).

In 1981, the IRS promulgated regulations defining the continuity of business enterprise requirement.<sup>87</sup> These regulations are now starting to receive interpretation by the courts and the IRS in revenue rulings.<sup>88</sup> These developments suggest that the continuity of business enterprise requirement may become a potent weapon of the IRS in denying reorganization treatment to transactions.

The continuity of business enterprise requirement first arose in several cases in which the courts held that the reorganization rules should not apply when the corporate business was liquidated and subsequently followed by the start-up of a new business of either the same or a different type.<sup>89</sup> To qualify for reorganization treatment, there must be continuation of the corporate enterprise.<sup>90</sup> Despite these cases, there was significant authority which held that continuity of business enterprise only requires that the acquiring company continue in some business after the transfer and that the shareholders of the acquired company continue their investment in corporate form.<sup>91</sup>

The 1981 Regulations added new facets to these judicially developed principles. The approach in the regulations is generally more liberal. Under the regulations, it is not necessary that the same corporate business continue wholly uninterrupted to qualify for reorganization treatment. Although the regulations are more liberal than the antecedent cases, they have their own complexities and create a number of new problems in the area. The regulations promulgated in this area are detailed and complex, yet they leave many questions unanswered and provide new opportunities for enterprising practitioners.

### B. General Rules

Under the regulations, there are two alternative tests that ensure the continuity of business enterprise requirement is met. The acquiring corporation (*P*) could either (1) continue the target corporation's (*T*) historic business or (2) use a significant portion of *T*'s historic business assets in a business.<sup>92</sup> The criteria for meeting these tests are not a model of clarity.

### C. Business Continuity

The requirement that *P* continue *T*'s historic business is satisfied if *P* continues the business *T* has been engaged in. The requisite continuity tends to be established if *P* is in the same line of business as *T*, but that alone is not sufficient.<sup>93</sup> To be absolutely certain of business continuity *P* apparently must continue *T*'s actual

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87. *Id.*

88. See *infra* text accompanying notes 127-30.

89. See, e.g., *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965) (Type F reorganization did not occur when a corporation sold its business assets to its former supplier and started in the same line of business one year later); *Standard Realization Co.*, 10 T.C. 708 (1948) (transaction which complied with the literal terms of a Type D reorganization held not to be a reorganization because of a pre-existing plan that the transferee would sell the assets).

90. See cases cited *supra* note 89.

91. See, e.g., *Becher v. Commissioner*, 22 T.C. 932 (1954), *aff'd*, 221 F.2d 252 (2d Cir. 1955); *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961).

92. Treas. Reg. § 1.368-1(d)(2) (1986). See also T.D. 7745, 1981-1 C.B. 134 (providing background and discussion of these regulations).

93. Treas. Reg. § 1.368-1(d)(3)(i) (1986).

business. If *T* has more than one line of business, *P* need only continue one of *T*'s several significant lines of business.<sup>94</sup> What constitutes a "significant" line of business for these purposes is to be determined by considering "all the facts and circumstances."<sup>95</sup>

A corporation's "historic business" is the business it has conducted most recently.<sup>96</sup> However, it cannot be a business that the corporation entered into so recently that conduct of the business is part of the plan of reorganization.<sup>97</sup> Thus, the "historic business" is a business that was conducted recently but not initiated too recently.<sup>98</sup>

#### D. Asset Continuity

The alternative test for satisfying the continuity of business enterprise requirement is asset continuity. This test requires that *P* use a significant portion of *T*'s "historic business assets" in a business.<sup>99</sup> *P* need not use *T*'s historic business assets in the same business as *T* used them, but *P* must use them in some business. Apparently *P* could use *T*'s assets in a way in which *T* had never used them. For example, *P*'s use of milk-delivery trucks to deliver dry cleaning would satisfy the test.<sup>100</sup>

A corporation's historic business assets are the assets used in its historic business. Business assets include not only tangible operating assets, but also stock, securities, and intangible operating assets such as goodwill, patents, and trademarks.<sup>101</sup>

The test is that *P* must use a "significant portion" of *T*'s historic business assets. The regulations do not provide a flat percentage test of how many of *T*'s assets constitute a "significant portion." Instead, the test is ambiguously stated to be that portion of a corporation's assets considered to be "significant" based on the relative importance of the assets to operation of the business.<sup>102</sup> Moreover, "all other facts and circumstances," such as the net fair market value of the assets used, will be considered.<sup>103</sup>

This ambiguity as to what constitutes a "significant portion" of *T*'s historic business assets is unwarranted. It adds unnecessary vagueness to an already vague and complex body of law. On occasions when a specific percentage of assets test has been useful, the IRS has provided one. For example, in order to qualify as a Type C reorganization, the target corporation must transfer "substantially all" of its assets to the acquiring corporation.<sup>104</sup> The IRS has ruled that "substantially all" of the target's assets for this purpose means "assets representing at least ninety percent of the fair

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94. Treas. Reg. § 1.368-1(d)(3)(ii) (1986).

95. Treas. Reg. § 1.368-1(d)(3)(iv) (1986).

96. Treas. Reg. § 1.368-1(d)(3)(iii) (1986).

97. *Id.*

98. See *infra* text accompanying notes 106-15.

99. Treas. Reg. § 1.368-1(d)(4)(i) (1986).

100. See *infra* text accompanying note 109.

101. Treas. Reg. § 1.368-1(d)(4)(ii) (1986).

102. Treas. Reg. § 1.368-1(d)(4)(iii) (1986).

103. *Id.*

104. I.R.C. § 368(a)(1)(C) (1986).



market value of the net assets, and at least seventy percent of fair market value of gross assets held by the target corporation immediately preceding the transfer.”<sup>105</sup> Presumably, a lower percentage test could be used for determining what constitutes a “significant portion” of *T*’s historic business assets for purposes of ascertaining the presence of asset continuity.

This vagueness indicates ineptness in the writing of these regulations. Presumably, the potential for such ineptness will continue even if some new vastly more “simplified” tax law is enacted.

### E. Examples in the 1981 Regulations

The regulations provide several examples demonstrating how the two alternative tests for establishing continuity of the business enterprise—business continuity and asset continuity—may or may not be met. These examples, however, do not provide a definitive discussion of the area and leave many questions unanswered.

#### 1. Business Continuity Satisfied

The first example concerns a case in which *T*, the acquired corporation, operates these separate lines of business: manufacture of synthetic resins, manufacture of chemicals, and distribution of chemicals.<sup>106</sup> The three lines are of approximately equal value. On July 1, 1981, *T* sells the synthetic resin and chemical distribution businesses to a third party for cash and marketable securities. On December 31, 1981, *T* transfers all of its assets to *P* solely for *P* voting stock. *P* continues the chemical manufacturing business without interruption. On these facts, the continuity of business enterprise requirement is met. Continuing only one of *T*’s significant lines of business is sufficient.<sup>107</sup>

In this example, it is interesting to note that *P* has used only thirteen percent of the fair market value of *T*’s assets, yet the continuity of business enterprise requirement is satisfied. However, if *P* had used thirteen percent of the assets of each of *T*’s three lines of business in a separate business of *P*’s, *P* clearly would not have satisfied either the business continuity or the asset continuity tests.<sup>108</sup>

#### 2. Asset Continuity Satisfied

The second example involves *P*, a manufacturer of computers and *T*, a manufacturer of components for computers.<sup>109</sup> *T* sells all of its output to *P*. On January 1, 1981, *P* decides to buy only imported components. On March 1, 1981, *T* merges into *P*. *P* continues buying imported components but retains *T*’s equipment as a backup source of supply. This constitutes the use of a significant portion of *T*’s

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105. Rev. Proc. 77-37, 1977-2 C.B. 568, 569.

106. Treas. Reg. § 1.368-1(d)(5) Example (1) (1986). The underlying facts in the example are similar to the facts in *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949). See also T.D. 7745, 1981-1 C.B. 134.

107. Treas. Reg. § 1.368-1(d)(5) Example (1) (1986).

108. See *infra* text accompanying notes 109-15.

109. Treas. Reg. § 1.368-1(d)(5) Example (2) (1986).

historic business assets by *P*. Therefore, asset continuity is satisfied and the continuity of business enterprise requirement is met.

Under this example, *P* used virtually all of *T*'s assets. Also, *P* did not continue *T*'s particular line of business (supplying *P* with computer components). The example states that *P* is not required to continue *T*'s business. The interesting issue posed by this example is what if *P* had used *T*'s assets in a way that *T* had never used them. For example, suppose *P* had used *T*'s assets to manufacture technical parts for jet aircraft, rather than as a backup supply for computer components. Presumably, this would satisfy the asset continuity test, but the example does not reach this question.

### 3. Business and Asset Continuity Not Satisfied

The third example concerns *T*, a manufacturer of boys' and men's trousers. As part of a plan of reorganization *T* sells all of its assets to a third party and then purchases a highly diversified portfolio of stocks and bonds on January 1, 1978. As part of the plan, *T* then operates an investment business until July 1, 1981. On that date, the plan of reorganization is completed by a transfer of *T*'s assets to *P*, a regulated investment company, solely in exchange for *P* voting stock. On these facts, the continuity of business enterprise test is not met because *T*'s investment activity is not its historic business and the stocks and bonds are not *T*'s historic business assets.<sup>110</sup>

This example is not particularly helpful because of the unusual fact that the steps taken were pursuant to a plan that extended over 3 1/2 years.<sup>111</sup> Rarely does a plan of reorganization last that long.

In addition, this example is unsettling in several other respects. Suppose the facts were the same as in the third example, except that the steps over the 3 1/2 years were not taken according to a plan of reorganization. Suppose the plan of reorganization involved only the last step—the transfer by *T* of its diversified portfolio to *P*. Now it seems much more likely that the transaction would meet the continuity of business enterprise requirement because the chances are better that *T*'s investment activity would be regarded as its historic business.<sup>112</sup> Therefore, if *T*'s investment activity was not entered into as part of the plan of reorganization, its investment activity would appear to meet the standards for being *T*'s "historic business." The regulations do reach this conclusion, however, and the ultimate effect of this example is unsettling.

In the fourth example, *T* manufactures toys and *P* distributes steel and applied products. On January 1, 1981, *T* sells all its assets to a third party for \$100,000 in cash and \$900,000 in notes. On March 1, 1981, *T* merges into *P*. The example

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110. Treas. Reg. § 1.368-1(d)(5) Example (3) (1986). Cf. *Workman v. Commissioner*, (1977) T.C.M. (P-H) 378; see also T.D. 7745, 1981-1 C.B. 134.

111. Treas. Reg. § 1.368-1(d)(5) Example (3) (1986).

112. A corporation's historic business is generally the business it has conducted most recently but is not one the corporation has entered into as part of the plan of reorganization. See *supra* notes 93-96 and accompanying text.

concludes that the continuity of business enterprise is lacking because "the use of the sales proceeds in *P*'s business is not sufficient."<sup>113</sup>

This example continues the unsettling theme established in the previous example. Suppose that the facts in this example were altered so that *T* held the cash and notes for 3 1/2 years before merging with *P*, but that *T* did not hold them pursuant to a plan of reorganization. Would the longer holding period establish that *T* had a "historic business" of holding cash and notes? If so, then the use by *P* of *T*'s cash and notes after the merger would give rise to asset continuity. However, perhaps holding cash and notes might not be considered a historic business no matter how long they have been held. Does *T* have to diversify its portfolio into stocks and bonds before it can be considered to have an investment business?

Further questions arise. Why is it that "the use of the sales proceeds in *P*'s business is not sufficient"<sup>114</sup> to establish continuity of business enterprise? Suppose *P* had taken the cash and notes acquired from *T* and held them as an ostensibly separate safe investment business. Could the situation then qualify for business continuity? In short, is the situation "not sufficient" because *T* did not establish a "historic business" by holding cash and notes for a few months or because, although *T* did establish a "historic business," *P* did not continue *T*'s line of business of holding cash and notes?

#### 4. Business Continuity Not Satisfied

In the fifth example, *P* operates a lumber mill and *T* manufactures farm machinery. *T* merges into *P*. *P* disposes of *T*'s assets immediately after the merger as part of the plan of reorganization. *P* does not continue *T*'s farm machinery manufacturing business. The regulations state that continuity of business enterprise is not present.<sup>115</sup>

The results in the fifth example are not particularly surprising. Nevertheless, some tantalizing questions are raised. Suppose the facts were the same except that *P* did continue *T*'s business. Since *P* has already sold *T*'s assets, *P* would be continuing *T*'s farm machinery manufacturing business with other assets that *P* had. The implication is that this variation would meet the test of business continuity. Thus, it appears that *P* could meet the business continuity test by continuing *T*'s specific business, even though it does not use *T*'s assets in the process. However, this conclusion is not quite certain.

#### F. Critique of the 1981 Regulations

The five examples are useful, but they do not answer the difficult questions. In some ways, they raise as many questions as they answer.

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113. Treas. Reg. § 1.368-1(d)(5) Example (4) (1986). These facts are a variation of the facts in Rev. Rul. 63-29, 1963-1 C.B. 77, although the results differ. See also T.D. 7745, 1981-1 C.B. 134.

114. Treas. Reg. § 1.368-1(d)(5) Example (4) (1986).

115. Treas. Reg. § 1.368-1(d)(5) Example (5) (1986).

It may be hypothesized that the IRS elaborated on the concept of the continuity of the business enterprise from pre-existing cases and promulgated the regulations simply to give themselves another weapon against tax-free reorganization transactions. Thus, it may be asked whether the continuity of the business enterprise requirement will be as potent as the continuity of interest doctrine,<sup>116</sup> the business purpose requirement,<sup>117</sup> and the step transaction doctrine.<sup>118</sup> Given the breadth of these other requirements, especially the latter two, it is difficult to imagine a transaction that could satisfy these other requirements and still fail to meet the continuity of business enterprise requirement.

Moreover, the vagueness of the regulations suggests that a substantial amount of case law and revenue rulings interpreting these regulations will develop. Unfortunately, these relatively recent regulations are probably going to make the field significantly more complex. The development of this additional layer of complexity, however, appears to be inevitable given the continuing pressure on the IRS to defend tax revenues and the continuing effort by taxpayers to plan tax-free transactions.

### G. Interpretation of the 1981 Regulations

#### 1. *Laure v. Commissioner*

Only a few cases interpreting the 1981 Regulations' delineation of continuity of business enterprise have been decided by the courts. In the leading case of *Laure v. Commissioner*,<sup>119</sup> the Sixth Circuit referred to the 1981 Regulations even though the transactions involved arose prior to the 1981 Regulations' effective date.

Laure, an individual, was the sole stockholder of two corporations: W-L Molding Company, a plastics manufacturer, and Lakala, a provider of air charter service. Lakala was originally formed solely to provide air charter service for W-L Molding, but later expanded to become a dealer for an aircraft manufacturer, in addition to performing other light manufacturing and mold inspection work for W-L.<sup>120</sup> Lakala was at first profitable, but later became unprofitable. It was insolvent at the time of the merger.<sup>121</sup>

For various business reasons, Lakala was merged into W-L. Immediately thereafter, W-L sold off Lakala's operating assets to Maurice Hovious pursuant to a pre-existing plan. W-L later sold the balance of Lakala's assets in transactions not related to the reorganization plan.<sup>122</sup>

The IRS asserted that the transaction lacked continuity of business enterprise because W-L eventually disposed of all the Lakala assets received in the merger.<sup>123</sup>

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116. See *supra* notes 37-46 and accompanying text.

117. See *infra* notes 153-91 and accompanying text.

118. See *infra* notes 192-243 and accompanying text.

119. 653 F.2d 253 (6th Cir. 1981).

120. *Id.* at 255. Lakala was formed as a separate transaction at the behest of W-L's bank in order to protect W-L's assets from exposure in the event of an air disaster.

121. *Id.*

122. *Id.* at 256.

123. *Id.* at 260.

The Sixth Circuit, however, held that not all of the transferor's pre-merger assets had to be held by the transferee in order to maintain continuity of the business enterprise.<sup>124</sup> W-L clearly did not have a preconceived plan to dispose of all the assets it received from Lakala. Although W-L never intended to operate Lakala's air charter and repair service, W-L clearly intended to retain other assets for use in its business.<sup>125</sup> Nor was it fatal that W-L sold a majority of the business assets it received from Lakala immediately after the merger according to a plan. "All that is required is that the transferee receive and continue to use some minimum amount of the transferor's assets."<sup>126</sup> "The assets retained by W-L were very valuable to its business."<sup>127</sup> Furthermore, Lakala's insolvency prior to the merger was not a bar to meeting the continuity of business enterprise test.<sup>128</sup>

The results in *Laure* appear to contradict the holding of the fifth example in the regulations.<sup>129</sup> Such a contradiction is unsettling to the administration of the tax laws. However, it is not surprising that several sources of tax law occasionally contradict each other.

## 2. Revenue Rulings

### a. Business of Acquiring Corporation

The thrust of the 1981 Regulations and *Laure* was the requirement of continuation of the target corporation's historic business or the use of the target corporation's historic business assets. But what of the acquiring corporation's historic business or historic assets? Must they also be continued? This fairly obvious question was not addressed by the regulations.

The IRS subsequently answered no. In Revenue Ruling 81-25,<sup>130</sup> the IRS addressed a fact pattern that had previously been analyzed in Revenue Ruling 63-29,<sup>131</sup> involving an acquiring corporation that sold its assets and discontinued its business and then acquired the assets of a target corporation in exchange for its voting stock. The acquiring corporation then used the proceeds from the sale of its assets to expand the business formerly conducted by the target corporation.

The IRS held, consistent with its previous holding in Revenue Ruling 63-29, that the transaction satisfied the continuity of business enterprise requirement.<sup>132</sup> The continuity of business enterprise requirement looks only to the historic business or assets of the target corporation.

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124. *Id.* at 261.

125. *Id.* at 260-61.

126. *Id.* at 261.

127. *Id.*

128. *Id.* at 261-62.

129. Treas. Reg. § 1.368-1(d)(5) Example (5) (1986). See *supra* text accompanying note 115.

130. Rev. Rul. 81-25, 1981-1 C.B. 132, 133.

131. Rev. Rul. 63-29, 1963-1 C.B. 77 (obsoleted by Rev. Rul. 81-25, 1981-1 C.B. 132).

132. Rev. Rul. 81-25, 1981-1 C.B. 132, 133.

This ruling is highly questionable. It certainly makes no sense to apply the continuity of business requirement solely to the target corporation.<sup>133</sup>

Because the continuity of business enterprise requirement looks only to the historic business or assets of the target corporation, it provides new planning possibilities for practitioners. Suppose it is contemplated that *A* will acquire *T* and then sell all *T*'s assets and not continue in *T*'s line of business. A transaction structured in this fashion would not meet the continuity of business enterprise requirement.<sup>134</sup>

However, if the transaction were structured so that *T* acquired *A*, and then *T*'s assets were sold, the transaction would meet the requirement.<sup>135</sup> Depending on other tax and business issues it may or may not be convenient to rearrange the transaction in this fashion. When the transaction can be structured in this manner, it provides an effective technique for planning around the continuity of business enterprise requirement. Thus, the IRS developed a doctrine, only to turn it into intellectual cannon fodder for shrewd practitioners. What guarantees that this somewhat inept process will cease if and when Congress enacts a different, supposedly simpler, statute? Indeed, a simpler statute is likely to place even more burdens of interpretation on the IRS which, with all due respect, has not shown itself to be up to the job.

#### b. *Transfers to Subsidiaries*

Suppose the acquiring corporation in a Type A reorganization transfers some or all of the assets received in the reorganization to one or more subsidiaries. Apart from questions of continuity of business enterprise, such a transaction could qualify as a Type A reorganization with a drop down of assets.<sup>136</sup> The ability to move assets among members of a controlled group without impairing the tax-free status of a reorganization is an important planning device. But does the possible distribution of these assets over more than one corporation undermine continuity of business enterprise? The IRS addressed this general problem in Revenue Ruling 81-247,<sup>137</sup> which dealt with three hypothetical situations.

In situation 1, *X*, a holding company, acquired a significant portion of the historic business assets of *Y*, a manufacturing business. At this point the transaction would satisfy the asset continuity test for determining whether continuity of business enterprise is present.<sup>138</sup> Immediately thereafter, however, *X* transferred all the assets received from *Y* to *Z*, its wholly-owned manufacturing subsidiary.<sup>139</sup>

In situation 2, the facts are the same as in situation 1, except that *X* was also engaged in a manufacturing business and *X* transferred less than a significant portion of *Y*'s assets to *Z* and retained less than a significant part of *Y*'s assets. (The total of

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133. See *supra* text accompanying notes 116-18.

134. Treas. Reg. § 1.368-1(d)(5) Example (5) (as amended 1980).

135. Rev. Rul. 81-25, 1981-1 C.B. 132, 133.

136. See I.R.C. § 368(a)(2)(C) (1986).

137. Rev. Rul. 81-247, 1981-2 C.B. 87.

138. See *supra* text accompanying notes 99-105.

139. Rev. Rul. 81-247, 1981-2 C.B. 87.

the assets *X* transferred to *Z* and the assets *X* retained constituted a significant portion of the historic business assets of *Y*). Both *X* and *Z* used *Y*'s assets in their separate manufacturing businesses.<sup>140</sup>

In situation 3, the facts are the same as in situation 1, except that *X* transferred part of the assets received from *Y* to each of three wholly-owned manufacturing subsidiaries. The assets transferred to the three subsidiaries each represented less than a significant portion of the historic business assets *X* received from *Y*. However, the total of the assets *X* transferred to the three subsidiaries represented all the assets *X* received from *Y*.<sup>141</sup>

In none of these three situations did *X* or any of its subsidiaries continue the historic trade or business of *Y*. Thus, the business continuity test<sup>142</sup> would not apply, and the only relevant test would be the asset continuity test.<sup>143</sup>

The IRS ruled that all three situations satisfy the continuity of business enterprise requirement.<sup>144</sup> The IRS held that "[t]he significant portion of *Y*'s historical business assets received by *X* remained with *X* or corporations directly controlled by *X*."<sup>145</sup>

### c. Critique

Although this ruling is helpful on particular facts presented, its theory is unclear. Suppose, for example, that instead of being wholly-owned subsidiaries, the subsidiaries involved in these three situations had been only eighty-five percent owned by the parent. Would that have caused the transactions to fail the asset continuity test?

The Revenue Ruling speaks in terms of the subsidiaries being "controlled" by the parent.<sup>146</sup> Although not stated in the Ruling, this presumably means control in the sense of at least the usual eighty percent stock ownership that is defined as "control" for other reorganization purposes.<sup>147</sup> It is troubling, however, that the Ruling deals only with facts involving 100 percent stock ownership. In the corporate sense, control of a subsidiary generally exists with over fifty percent stock ownership. Presumably this would be insufficient here, although perhaps one may look to the continuity of interest standards,<sup>148</sup> in which fifty percent equity consideration is sufficient.

Moreover, asset continuity<sup>149</sup> deals with concepts of proportion of business assets acquired. If acquired assets are transferred to eighty percent subsidiaries, does this mean that only eighty percent of the subsidiary's assets are counted in attempting to ascertain whether a "significant portion" of the target's business assets have been

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140. *Id.*

141. *Id.*

142. See *supra* text accompanying notes 91-98.

143. See *supra* text accompanying notes 99-105.

144. Rev. Rul. 81-247, 1981-2 C.B. 87-88. This ruling cited with approval Rev. Rul. 68-261, 1968-1 C.B. 147, in which a parent corporation acquired all the assets of a target corporation which had conducted its business through six divisions. Immediately thereafter, the parent transferred the assets of each of the six divisions of the target to six wholly owned subsidiaries. The ruling concluded that the transaction qualified as reorganization under sections 368(a)(1)(A) and 368(a)(2)(C).

145. *Id.*

146. *Id.*

147. I.R.C. § 368(c) (1986).

148. See *supra* notes 37-46 and accompanying text.

149. See *supra* text accompanying notes 99-105.

acquired? Suppose the assets are transferred to a second tier subsidiary which is eighty percent owned by a first tier subsidiary which is eighty percent owned by the parent. Should only sixty-four percent (eighty percent of eighty percent) of the target corporation's assets acquired by the second tier subsidiary be considered when ascertaining whether a "significant portion" of the target corporation's assets have been acquired?

If this analysis is correct, then it would be possible to fail the asset continuity test even though 100 percent of the target's assets have been acquired. This result occurs because the target's assets could be transferred to second and third tier eighty percent subsidiaries, which would cause less than 100 percent of the target's assets to be considered in determining whether a "significant portion" of the target's historic business assets have been acquired.

None of these question have been answered. This nebulous situation will lead to practitioners taking various steps to avoid being challenged by the IRS. One step would be to transfer assets only to 100 percent controlled subsidiaries. Another step would be to acquire all of the target corporation's assets to lessen the possibility that the IRS will question whether a "significant portion" of the target corporation's business assets have been acquired.<sup>150</sup>

#### H. Criticism

Planning requires a degree of certainty in the rules faced. Since the continuity of business enterprise requirement was created by the regulations, it might have been expected that the doctrine would have been defined by the IRS in detail, leaving few unanswered questions. Nothing could be further from the truth. The requirements set forth in the regulations lack numerical or other clear standards for determining what constitutes a significant line of business, what constitutes a historic business, or what constitutes a significant portion of T's historic business assets. The subsequently issued Revenue Rulings<sup>151</sup> similarly lack detail, ironically resulting in a judicially developed continuity of interest doctrine that has much clearer standards.

Because the continuity of business enterprise requirement looks only to the historic business or assets of the acquired corporation, clear planning possibilities are presented. If possible, practitioners will structure the transaction so the corporation whose assets are to be sold would be the acquiring corporation. Thus, the doctrine elicits useless additional planning by practitioners and their clients. In addition, the explication of the doctrine by the IRS has left many unanswered questions concerning what constitutes the target corporation's historic business or its historic assets.<sup>152</sup>

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150. These problems may be compared to the problems of "asset tailoring," or the spinning off of unwanted assets prior to the reorganization. See *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938).

151. See *supra* text accompanying notes 137-45.

152. See Bloom, *The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise*, 7 J. CORP. TAX 'N 315 (1981); Faber, *Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?*, 34 TAX. LAW. 239, 268-95 (1981); Libin, *Continuity of Business Enterprise: The New Regulations*, 39 N.Y.U. INST. ON FED. TAX. CH. 4 (1981).



## VII. BUSINESS PURPOSE AND SUBSTANCE OVER FORM

## A. Background

Once the judicially developed doctrine of continuity of proprietary interest and the administratively developed doctrine of the continuity of the business enterprise requirements have been satisfied, the parties still are not assured of the transaction qualifying as a Type A reorganization. The IRS must also be satisfied that the transaction has a "business purpose." Another way of viewing this problem is to say that the substance of a transaction will control over its form.

B. *Gregory v. Helvering*

The requirement of a business purpose, which is found in several places in the Regulations under section 368,<sup>153</sup> was developed from the classic Supreme Court case of *Gregory v. Helvering*.<sup>154</sup> The influence of *Gregory* in the field of corporate reorganizations cannot be overstated. *Gregory* virtually holds analysis in the field of corporate reorganizations together.<sup>155</sup> It is ironic that an area as heavily encompassed by a statute, like the field of corporate reorganizations, should ultimately be controlled by a fifty year old Supreme Court case. Even though a transaction touches all the modern statutory bases, it must still satisfy the business purpose test of *Gregory*.<sup>156</sup>

In *Gregory*, Mrs. Evelyn F. Gregory was the sole stockholder of United Mortgage Company. United Mortgage owned, among its other assets, 1,000 shares of Monitor Securities Corporation. Mrs. Gregory wished to sell the Monitor Securities stock, but not the other holdings of United Mortgage. She did not want the Monitor Securities stock distributed to herself as a dividend, taxable at ordinary income tax rates, and she did not wish to liquidate United Mortgage.<sup>157</sup>

Therefore, Mrs. Gregory formed Averill Corporation and caused United Mortgage to transfer all the stock of Monitor Securities to Averill. In exchange, Averill issued all its stock to Mrs. Gregory. Three days after receiving the Averill stock, Mrs. Gregory caused Averill to be liquidated.<sup>158</sup> The liquidation was tax-free to Mrs. Gregory under the reorganization statute of that time.<sup>159</sup> As a result, Mrs. Gregory took a low carryover basis in the Monitor stock and incurred only a capital gain upon the subsequent sale of it.

The Supreme Court conceded that the transaction had complied with the statute.<sup>160</sup> Nevertheless, the Court held that the transaction was "an operation having no business or corporate purpose," but was "an elaborate and devious form

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153. See Treas. Reg. § 1.368-1(b); § 1.368-1(c) (as amended 1980); § 1.368-2(g) (as amended 1985).

154. 293 U.S. 465 (1935).

155. Indeed, *Gregory* is a fundamental building block of the entire field of substance over form. See D. Posin, *supra* note 11, at 268.

156. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

157. *Id.* at 467.

158. *Id.*

159. I.R.C. § 112(g), Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 791.

160. *Gregory v. Helvering*, 293 U.S. 465, 469 (1935).

of conveyance," and that allowing the taxpayer to succeed would "exalt artifice above reality and . . . deprive the statutory provision in question of all serious purpose."<sup>161</sup>

Thus originated the doctrine that a transaction must have a business purpose to qualify for the statute's tax-free treatment. Touching all the bases of the statute without a business purpose is not sufficient.<sup>162</sup>

### C. *The Progeny of Gregory*

#### 1. *Development of the Business Purpose Requirement*

*Gregory* has been widely cited in the reorganization area, as well as other areas of the tax law. Several major cases subsequently expanded the already broad approach of *Gregory*.

*Commissioner v. Court Holding Company*,<sup>163</sup> the most important of these cases, involved negotiations by a corporation for the sale of property which led to an oral agreement. Before the agreement was reduced to writing, the corporation's attorney advised the parties that for tax purposes the corporation should first liquidate and then have its shareholders sell the property.<sup>164</sup> This would avoid double taxation—taxation of the corporation on the sale, and taxation of the shareholders on the subsequent liquidation of the corporation. By liquidating the corporation first there would be only one tax—taxation of the shareholders on the liquidation. There would be no additional tax to the shareholders on the subsequent sale, because their basis in the property would have been stepped-up to its fair market value after the liquidation.

The Supreme Court held that "[t]he incidence of taxation depends upon the substance of a transaction."<sup>165</sup> Therefore, the substance of the whole transaction should control over the form and the corporation should be regarded as having made the sale.<sup>166</sup>

#### 2. *Corporate Versus Shareholder Purpose*

Further refinement and development of the business purpose doctrine has continued. Until courts stop deciding cases, this is presumably a process that will continue regardless of any new statute that may be enacted.

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161. *Id.* at 470.

162. The *Gregory* holding is no longer necessary to prevent the particular maneuver engaged in by Mrs. Gregory. The statute now requires that a corporate spin-off of the type engaged in by Mrs. Gregory will now be tax-free only if the shares spun-off represent ownership of an active trade or business which has been conducted over the preceding five years if the maneuver is not a "device for the distribution of earnings and profits" of the distributing or spun-off corporation. See I.R.C. § 355(a) and (b) (1986).

163. 324 U.S. 331 (1945).

164. *Id.* at 333.

165. *Id.* at 334.

166. See I.R.C. § 337 (1986) (The Tax Reform Act of 1986 repealed § 337. CONFERENCE REPORT, *supra* note 4, at II 198-200).

The cases since *Gregory* have not only expanded the already broad view of a requirement of a business purpose, but also have explored the question of whose business purposes had to be served: Could only the corporation's business purpose be served or would serving the shareholders' business purpose suffice? At least in closely-held corporations, the answer is that serving the shareholders' business purposes will satisfy the *Gregory* test.

In *Lewis v. Commissioner*,<sup>167</sup> a corporation was engaged in three lines of business: The manufacture of synthetic resins, the manufacture of chemicals for the textile industry, and distribution of chemicals. The corporation sold the synthetic resins business and the chemicals distribution business. The directors did not want to leave the cash obtained from the sale at risk in the chemical manufacturing business. Therefore, the operating assets were transferred to a new corporation in exchange for its stock. The new corporation's stock and cash were subsequently distributed to the shareholders. In a reversal of customary roles, the IRS argued that a reorganization had taken place with a "boot" dividend to the shareholders.<sup>168</sup>

Clearly, all the statutory steps for a reorganization had taken place.<sup>169</sup> The taxpayers, however, argued that no reorganization had taken place because the creation of the new company and the transfer to it of the chemical manufacturing business was for the purpose of isolating the liquid assets of the old corporation from the risk of the chemical manufacturing business. According to the taxpayers, this served a shareholder purpose, not a corporate purpose. The old corporation could have continued to run the business in the same corporate solution with the liquid assets. Thus, only the shareholder purpose of limiting liability was served by the transaction. Therefore, the taxpayers argued *Gregory* required a corporate business purpose for a reorganization.<sup>170</sup>

The Court rejected this argument and held that it is unrealistic to seek to distinguish between a corporate business purpose and a shareholder business purpose, particularly with respect to closely-held corporations. Since a shareholder business purpose existed, there was a business purpose that satisfied the requirements of *Gregory*.<sup>171</sup>

A similar situation was presented in *Estate of Parshelsky v. Commissioner*<sup>172</sup> which involved a closely-held corporation engaged in a wholesale lumber and millwork business. The sole shareholder, Moses Parshelsky, formed a new corporation to which the old corporation transferred its real estate in exchange for the stock of the new corporation. The stock of the new corporation was then immediately

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167. 176 F.2d 646 (1st Cir. 1949).

168. I.R.C. §§ 354, 356(a)(2) (1986). "Boot" includes any money or property other than securities of a controlled corporation, received as a result of reorganization. Any boot received is taxable to the shareholder as a dividend.

169. *Lewis v. Commissioner*, 176 F.2d 646, 648 (1st Cir. 1949).

170. *Id.* at 649.

171. *Id.* at 649-50. The court declined to follow a line of cases which had suggested that a distinction should be drawn between a corporate business purpose and a shareholder business purpose in closely-held corporations. *See, e.g.*, *Wellhouse v. Commissioner*, 3 T.C. 363 (1944); *Bazley v. Commissioner*, 4 T.C. 897 (1945), *aff'd*, 155 F.2d 237 (3d Cir. 1946), *aff'd*, 331 U.S. 737 (1947); *Adams v. Commissioner*, 5 T.C. 351 (1945), *aff'd*, 155 F.2d 246 (3d Cir. 1946), *aff'd*, 331 U.S. 737 (1947).

172. 303 F.2d 14 (2d Cir. 1962).

distributed, or spun-off, to Parshelsky. Simultaneously, the new corporation leased the real estate back to the old corporation for use in the lumber and millwork business. The old corporation also had the right to sublet up to fifty percent of the space of the building.<sup>173</sup>

Parshelsky claimed that the transaction was a valid reorganization and the distribution of the stock of the new corporation was tax-free under the relevant provision of the Internal Revenue Code of 1939.<sup>174</sup> The IRS argued that although the transaction met the literal terms of the statute, it was not tax-free because of failure to show a business purpose for the transaction.<sup>175</sup>

The reasons given by Parshelsky for engaging in the transaction were: To remove the valuable real estate from the hazards of the declining wholesale business; to spare employees who might take over the wholesale business after Parshelsky's death from having to deal with the real estate; to allow Parshelsky's successors to continue to own the real estate regardless of the fate of the wholesale business; and to allow the real estate to be available for Parshelsky's executors as a separate asset of the estate.<sup>176</sup>

These were clearly shareholder and not corporate reasons. The Tax Court held that shareholder business reasons would not support a reorganization under *Gregory*.<sup>177</sup> The Second Circuit remanded the case to the Tax Court for reconsideration with the instruction that a valid shareholder business purpose would support a reorganization.<sup>178</sup> Thus, *Lewis* and *Estate of Parshelsky* have established that at least in the closely-held corporation setting, a shareholder business purpose for the reorganization will satisfy *Gregory*.

Although the facts of these cases favored the IRS, they weakened the business purpose requirement because it has become easier to show a business purpose. Therefore, these cases benefit future taxpayers who wish to qualify their transaction as a reorganization. Thus, the underlying rationale of the Supreme Court in *Gregory* was eroded by *Lewis* and *Estate of Parshelsky*.<sup>179</sup>

#### D. Critique

The preceding discussion demonstrates that the business purpose requirement and the doctrine of substance over form are major factors in the field, rivaling the

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173. *Id.* at 14-16.

174. 26 U.S.C.A. § 112(b)(11) (1950).

175. *Estate of Parshelsky v. Commissioner*, 303 F.2d 14, 17 (2d Cir. 1962).

176. *Id.* at 16-17. In discussing these reasons, the court took a surprisingly aggressive approach in second-guessing these reasons and offering alternative ways in which these goals could have been accomplished without engaging in the spin-off. *Id.* at 20-21. Presumably the standard for determining a business purpose should not be whether the court can successfully second-guess the taxpayer's advisors as to whether there are alternative ways to accomplish the taxpayer's goals.

177. *Estate of Parshelsky v. Commissioner*, 34 T.C. 946, 953 (1960).

178. *Estate of Parshelsky v. Commissioner*, 303 F.2d 14, 23 (2d Cir. 1962).

179. The logic supporting the approach discussed in the text would break down in the case of a publicly-held corporation, in which the interests of the corporation and its shareholders are not necessarily identical. There are no cases involving the issue of shareholder business purpose in a reorganization of publicly-held companies.

continuity of interest doctrine in importance.<sup>180</sup> However, the continuity of interest doctrine has clear numerical standards for ascertaining if its requirements are met.<sup>181</sup> The business purpose requirement has no such clear test. In the final analysis, all we have in the business purpose area is a welter of cases and regulations that serve general warnings to taxpayers not to try anything too clever, but which do not articulate an overall standard. The existence of such a vague, yet important, doctrine is unfortunate from the standpoint of tax administration. What indeed is a business purpose? To what extent may courts examine the reasons for a transaction and pass upon their adequacy or effectiveness? Should courts, as in *Estate of Parshelsky*, analyze the business purposes to be served and suggest alternative ways to better achieve ends that do not involve a reorganization?<sup>182</sup> If better ways exist, is the taxpayer's business purpose invalid and is the transaction therefore taxable? Is this area to become a contest in business planning between taxpayers' counsel and judges?

It has been suggested by some commentators that *Gregory* was wrongly decided and the business purpose requirement should be eliminated. Courts should apply the statute technically and let Congress deal with the problem of manipulative taxpayers.<sup>183</sup> The simplicity of this approach has a certain superficial attractiveness.

It would be unwise, however, for courts to allow taxpayers to obviously flout the statute's intent. In the absence of the business purpose requirement, Congress would have to cure every abusive maneuver that meets the literal terms of the statute.

Moreover, each time Congress would enact such a prophylactic measure, new avoidance potential would be presented by the new statutory language, giving impetus to more tax legislation and increasing the complexity of the statute. Why should the courts play the role of literal-minded automatons in this process, effectively aiding the taxpayers' evasive maneuvers?

Furthermore, if the courts took this literal-minded approach, Congress would undoubtedly enact broad statutory language giving the IRS power to promulgate regulations to deal with attempts by taxpayers to flout the purpose of the law. Therefore, the power of the business purpose and step transaction doctrines would emanate from the IRS rather than from the courts. Presumably the critics of the business purpose and step transaction doctrines would prefer to see these doctrines wielded by the courts rather than by the IRS.

If the business purpose and step transaction doctrines do play, and will continue to play, an important role in the law of reorganizations, what lines may be drawn? How can the practitioner be assured that his transaction will not be invalidated? Most importantly, what are the appropriate standards from a policy standpoint?

The Internal Revenue Code clearly allows or contemplates that a choice may be made based solely on tax consequences in other situations: The decision to do

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180. The doctrine that substance should control over form has been called "the cornerstone of sound taxation." *Estate of Weinert v. Commissioner*, 294 F.2d 750, 755 (5th Cir. 1961).

181. See *supra* text accompanying notes 37-46.

182. See *supra* note 178.

183. See Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859, 879-83 (1982).

business in corporate or partnership forms,<sup>184</sup> the decision to elect Subchapter S,<sup>185</sup> the decision to file consolidated returns,<sup>186</sup> the decision to income average,<sup>187</sup> and the decision to use accelerated cost recovery.<sup>188</sup>

These transactions may be distinguished from transactions such as that in *Gregory* in which a straight tax election was not invited explicitly or implicitly. Rather, what occurred in *Gregory* and its progeny was that pointless activity was undertaken to comply with the statute to obtain favorable tax consequences.<sup>189</sup>

What lesson emerges from this discussion for the tax practitioner in planning a tax-free reorganization and for the administration of the tax laws? A business purpose seems to mean a legitimate non-tax reason. There must be potential for a pre-tax profit from the transaction.<sup>190</sup> However, favorable tax consequences will not necessarily invalidate the transaction. However, if the reorganization is pointless apart from tax consequences, then it would seem to lack a business purpose and could be vulnerable to attack by the IRS.

Based on this analysis, it is difficult to conceive of a new statute that would avoid the problem of taxpayers touching all the bases without a business reason just to obtain a tax benefit. Because transactions are complex in this area, and tax advisors are very innovative, it is hard to imagine any statute not supported by a judicial doctrine like the requirement of a business purpose. Thus, here is another source of complexity that appears to be a permanent fixture regardless of how the statute may be redrawn.<sup>191</sup>

## VIII. THE STEP TRANSACTION DOCTRINE

### A. Background

Related to the business purpose requirement is the step transaction doctrine. Under the step transaction doctrine, several steps taken by taxpayers in effecting a reorganization will be put together ("stepped together") by the IRS or the courts to ascertain the tax consequences.<sup>192</sup> Thus, a purchase of stock followed by a liquidation of the target may be stepped together and treated as a purchase of assets,

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184. I.R.C. §§ 351 (tax-free incorporation), 721 (tax-free formation of a partnership) (1986).

185. I.R.C. § 1362 (1986).

186. I.R.C. § 1501 (1986).

187. I.R.C. § 1301-1304 (1986). See also D. POSIN, *supra* note 11, at 409-12. The option to income average was repealed by the Tax Reform Act of 1986. (CONFERENCE REPORT, VOL. II, *supra* note 4, at 11).

188. I.R.C. § 186 (1986). See also D. POSIN, *supra* note 11, at 314-18.

189. See *supra* text accompanying notes 154-79.

190. The minimum requirement seems to be a reasonable profit potential. A profit potential limited to \$1 probably would not suffice, although there are no authorities speaking specifically to the matter.

191. See generally Willens, *The Significance of Form: Some Subchapter C Manifestations*, 12 J. CORP. TAX'N 72 (1985); Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968); Bittker, *What is "Business Purpose" in Reorganizations?*, 8 N.Y.U. INST. ON FED. TAX'N 134 (1950).

192. One of the earliest statements of the step transaction doctrine was in *Warner Co. v. Commissioner*, 26 B.T.A. 1225, 1228 (1932), in which the court stated that an examination of several steps that led to a reorganization was permissible under the statute of that time (§ 204(a)(7), Revenue Act of 1926). See also *Carter Publications, Inc. v. Commissioner*, 28 B.T.A. 160, 164 (1933).

with significantly different tax consequences.<sup>193</sup> The doctrine is usually invoked by the government against taxpayers, but taxpayers may also attempt to employ it.<sup>194</sup>

B. *Sale of Stock Plus Merger*: King Enterprises, Inc. v. United States

1. *Background*

Results of the five basic types of acquisitive transactions overlap to a substantial degree. However, they have differing requirements for consideration and other matters.<sup>195</sup> Therefore, it is of great importance to ascertain which type of transaction is deemed to have occurred. These problems are illustrated in the leading case of *King Enterprises, Inc. v. United States*,<sup>196</sup> the results of which provide further insight into the roots of tax complexity.

In *King*, taxpayer King Enterprises, a corporation, was one of eleven shareholders of Tenco, Inc., a corporation engaged in supplying coffee. On September 3, 1959, the shareholders, for various business reasons, sold their Tenco stock to Minute Maid for approximately \$3,000,000 cash, \$2,550,000 in notes, and \$5,771,926 in Minute Maid stock.<sup>197</sup> Thus, the transaction involved more than fifty percent of the consideration being Minute Maid stock. King received a proportionate share of each of these types of consideration.

On December 10, 1959, the directors of Minute Maid approved a plan to merge the company's four subsidiaries, including Tenco, into the parent company. On January 5, 1960, Minute Maid requested a ruling from the IRS concerning the basis Minute Maid would take in Tenco's assets upon a merger of Tenco into Minute Maid. The IRS responded favorably on February 25, 1960.<sup>198</sup> On April 30 and May 2, Tenco and other subsidiaries were merged into Minute Maid.

It was undisputed that a Type A reorganization had taken place when Tenco merged into its parent Minute Maid.<sup>199</sup> King argued, however, that the transfer of the Tenco stock to Minute Maid for cash, notes, and Minute Maid stock should be stepped together with the merger of Tenco into Minute Maid, making the entire transaction a merger of Tenco into Minute Maid. Under this approach, King and other shareholders of Tenco would qualify for tax-free treatment of the stock portion of

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193. This particular problem is now covered by section 338, which provides for an election to obtain a stock basis in the assets of an acquired subsidiary if certain requirements are met. I.R.C. § 338 (1986).

194. See *infra* text accompanying notes 213–23. See also Jacobs, *Supreme Court Further Restricts the Step Transaction Doctrine*, 29 J. TAX'N 2 (1968).

195. See *supra* notes 16–17 and accompanying text.

196. 418 F.2d 511 (Ct. Cl. 1969).

197. *Id.* at 513.

198. *Id.* at 514. Minute Maid wished to establish that it would be able to apply the basis of its Tenco stock to the Tenco assets, pursuant to former section 334(b)(2) (repealed by Sec. 224 (b) of Pub. L. No. 97–248, Sept. 3, 1982). The facts of *King* are now covered by § 338, which allows an election to step-up the basis of the assets of the acquired subsidiary without the necessity of an actual liquidation. I.R.C. § 338 (1986). Although the particular technical approach for stepping up the basis of the assets in an acquired subsidiary has changed, the underlying concern of *King*—whether the particular steps in a transaction should be amalgamated—remains of great importance.

199. *Id.* at 515.

their consideration.<sup>200</sup> Moreover, King argued that the cash and notes should be treated as a dividend qualifying for the eighty-five percent dividend received deduction for corporate shareholders.<sup>201</sup>

The IRS asserted that the transfer of Tenco stock to Minute Maid was a transaction independent from the merger of Tenco into Minute Maid. Therefore, King and the other stockholders were not shareholders of a merged corporation and were not entitled to nonrecognition on the sale of their Tenco stock.<sup>202</sup> Moreover, King's entire gain on the transaction would be capital gain, less favorable for corporations because of their inability to use the intercorporate dividends deduction for capital gains.

Thus, this case involved the use of the step transaction doctrine by the taxpayer and an argument by the IRS that the form of the transaction should be respected, a reversal of their usual positions.<sup>203</sup>

The court combined the steps and held that King should receive its Minute Maid stock tax free.<sup>204</sup> The court explicitly rejected the requirement that there had to be a "binding commitment" to take the two steps in question before it would apply the step transaction doctrine to amalgamate the steps. In the court's view, the step transaction doctrine "derives vitality . . . from its application where the form of the transaction *does not require* a particular further step be taken . . . ."<sup>205</sup>

The court used a mixture of the "end result" and "interdependence" tests and concluded that Minute Maid's overall intention was to liquidate Tenco after acquiring it to gain the tax benefit of a step-up in Tenco's assets for subsequent depreciation purposes, as well as to secure certain other non-tax savings.<sup>206</sup> Thus, King's sale of stock was stepped together with Minute Maid's subsequent liquidation of Tenco and King was therefore entitled to nonrecognition on the stock portion of its consideration and dividend treatment, subject to the intercorporate dividends received deduction, on the balance.<sup>207</sup>

## 2. Critique

*King* seems to have been incorrectly decided and raises troublesome policy questions. From whose point of view is the step transaction doctrine to be applied?

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200. *Id.* at 514. See also I.R.C. §§ 354, 356 (1986). Consistent with these statutory provisions, it was not disputed that the cash and notes would be taxable.

201. *King Enters., Inc. v. United States*, 418 F.2d 511, 514 (Ct. Cl. 1969). Dividend treatment for boot in a reorganization is governed by I.R.C. § 356(a)(2) (1986). The authority for the 85% intercorporate dividend deduction is I.R.C. § 243(a)(1) (1986). The IRS has ruled that the deduction is available to corporations receiving boot dividends in a reorganization. Rev. Rul. 72-327, 1972-2 C.B. 197. See also *American Mfg. Co. v. Commissioner*, 55 T.C. 204, 215 (1970).

The Tax Reform Act of 1986 repealed the preference for capital gains, while retaining the limitations on deductibility of capital losses. The Tax Reform Act of 1986 also reduced the 85% dividends received deduction to 80%. CONFERENCE REPORT, *supra* note 4, at II 105-II 107.

202. *King Enters., Inc. v. United States*, 418 F.2d 511, 517-18 (Ct. Cl. 1969).

203. See *supra* text accompanying notes 151-52.

204. *King Enters., Inc. v. United States*, 418 F.2d 511, 519 (Ct. Cl. 1969).

205. *Id.* at 518 (emphasis in original).

206. *Id.* at 518-19.

207. *Id.* at 519-22.



In *King*, it was not the taxpayer who engaged in the steps that were combined. Rather, it was Minute Maid which took the interdependent steps of purchasing Tenco stock and then liquidating Tenco. Although the result was favorable to the taxpayer, the decision has left an uneasy legacy for other taxpayers in similar circumstances.

Suppose, for example, that one of the other stockholders of Tenco had an unrealized loss on its Tenco stock. Such a taxpayer would be unable to recognize a loss on what appears to be a simple sale of his stock, just because the purchaser—without notice or control by any of the selling stockholders—decides to liquidate the company soon after the purchase, causing gains and losses to the sellers to go unrecognized.<sup>208</sup>

This example suggests that *King* was wrongly decided. *Gregory*,<sup>209</sup> the original step transaction business purpose case, involved a taxpayer whose nefarious scheme to avoid taxes involved steps taken under the taxpayer's control. Such a taxpayer could understandably accept having the transaction rewritten by the court so she could not obtain the tax benefits for which she had planned.

However, taking the relatively severe step of informing a taxpayer that a transaction is not what it seems, or is purported to be, but is rather something else, should be done only when the steps to be combined have been taken by the taxpayer. The decision in *King* has introduced a further unpredictable factor into an already complex field.

Another strange possibility in cases like *King* is that the step transaction doctrine might be applied to one of the parties and not the other. For example, in *King* a reasonable result might have been to apply the step transaction doctrine to Minute Maid, since it was Minute Maid that took the steps. Thus, the sale of stock plus the liquidation of the subsidiary could have been combined as to Minute Maid. However, the step transaction doctrine might not have been applied to *King*, which did not take the steps to be combined. Therefore, the transaction would have been simply a taxable sale of stock to *King* and other Tenco shareholders.

Although this inconsistent application sounds strange, such an approach is not without precedent.<sup>210</sup> This approach would be consistent with *Gregory*,<sup>211</sup> in which the doctrine was applied to the party who actually took the steps.

In *King*, the actions of the buyer changed the tax consequences to the seller. In *McDonald's Restaurants of Illinois v. Commissioner*,<sup>212</sup> the actions of the seller changed the tax consequences to the buyer. Thus, one clear lesson to be drawn from these leading cases is that the seller and the buyer should obtain information about the other's future intentions in any sale of a corporate business. This exchange would be advisable whether the transaction is structured to be taxable or tax-free. As *King* demonstrates, a transaction which originally is structured to be taxable can be

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208. The general rule is that no gain or loss is recognized by the shareholders participating in a reorganization. I.R.C. § 354 (1986).

209. See *supra* text accompanying notes 154–62.

210. *Kass v. Commissioner*, 60 T.C. 218, 221–22 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974) (dicta to the effect that the step transaction doctrine could apply at the shareholder level but not at the corporate level).

211. See *supra* text accompanying notes 154–62.

212. See also *infra* text accompanying notes 215–25.

converted into one that is tax-free by unilateral actions of the seller or the buyer.<sup>213</sup> Similarly, one that is structured to be tax-free can be converted into a taxable transaction by the unilateral action of either party. In these cases, the other party to the transaction may often be unpleasantly surprised.

If there is any serious question what either party may do subsequent to the transaction, the parties should contract for what steps subsequent to the transaction will or will not be taken. Given the nature of the transaction, contracting to *not* take steps may be important.

Such contractual provisions, however, may influence the tax treatment of a transaction. Contracting to take certain subsequent steps conjures up the “binding commitment” test,<sup>214</sup> and would assure that the subsequent steps would be combined with the transaction. The parties may or may not desire this result. Similarly, contracting *not* to take certain subsequent steps could be helpful in establishing that the steps taken in the transaction have independent significance. Contracting for future behavior, if the parties can agree, can enable the parties to reduce the step transaction doctrine’s inherent unpredictability.

However, to the extent that taxpayers begin to contract for future behavior, agreements will become even more complex and the necessity for further negotiations could undermine the entire deal. Nevertheless, it is difficult to see how these problems can be legislated away, as long as the courts attempt to apply the statute in a reasonable way.

### C. *Breaking Post Merger Continuity of Interest: McDonald’s Restaurants of Illinois v. Commissioner*

Among the issues illustrated by *McDonald’s Restaurants of Illinois v. Commissioner*<sup>215</sup> is the overlap of the continuity of interest doctrine, the step transaction doctrine, and the doctrine of substance over form.<sup>216</sup> Moreover, *McDonald’s*, like *King*, involved the relatively unusual circumstance of the taxpayer seeking to apply a judicial doctrine to assert that a reorganization had not occurred. The *McDonald’s* opinion contains an excellent discussion of the step transaction doctrine. The Seventh Circuit’s opinion in *McDonald’s* illustrates the interaction of the variety of complex forces in the reorganization field.

In *McDonald’s*, the McDonald’s Corporation acquired twenty-seven fast-food restaurants of one of its franchisees in a statutory merger under Delaware law. The sellers wanted only cash as their consideration, but McDonald’s wanted to give only stock so it could use “pooling of interests” accounting. As a compromise, the parties agreed that McDonald’s would give solely stock, but would include the stock in a planned registration and sale of stock to the public six months later so the sellers could sell the stock in the near future. Alternatively, the sellers could elect to participate in any later registration and sale of stock that McDonald’s might engage

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213. See *supra* text accompanying notes 196–207.

214. See *infra* text accompanying notes 226–29.

215. 688 F.2d 520 (7th Cir. 1982).

216. See *supra* notes 37–46, 86–152, 192–94 and accompanying text.

in during the ensuing six years. If McDonald's did not engage in a registration and sale within one year, the sellers would have the right to demand registration of their stock. The sellers could also choose to retain their stock.<sup>217</sup>

Six months after the acquisition, McDonald's registered and sold a new issue of stock, to which the sellers "piggy-backed"<sup>218</sup> their shares. Thus, the sellers received cash upon registration and sale of their stock. The issue in the case was the basis, for purposes of depreciation, of the assets the sellers had transferred in the hands of McDonald's.

Since the fair market value of the assets was greater than their basis in the hands of the sellers, McDonald's wanted the assets to be stepped-up to their fair market value for purposes of depreciation, while the IRS argued that the basis of the assets should be carried over at the sellers' lower basis. Thus, the parties switched their usual position—taxpayer McDonald's argued that a reorganization had not taken place, while the IRS argued that a reorganization was present.<sup>219</sup>

In arguing that a reorganization was not present, McDonald's invoked the step transaction doctrine, asserting that the transfer for stock plus the subsequent sale by the sellers for cash should be stepped together. Since the sellers ultimately received cash as consideration, continuity of interest was not present, and therefore the transaction was not a reorganization.<sup>220</sup>

The court held in favor of McDonald's, finding that the subsequent sale for cash by the sellers broke post-reorganization continuity.<sup>221</sup> In reaching that decision, the court examined the three main approaches to the step transaction doctrine.<sup>222</sup> The court found that under at least two of the three tests, the transaction should be stepped together. Under the "end result" and "interdependence" test the transaction should be stepped together. This was because an essential element of the agreement was the sellers' ability to force McDonald's to register and sell their stock.<sup>223</sup>

*McDonald's* appears to have been incorrectly decided for the same reason as *King*, namely because the taxpayer to whom the step transaction doctrine was applied was not the one who took the steps that were combined.<sup>224</sup> The situation in *McDonald's* is not as egregious as it was in *King* because the parties in *McDonald's* contemplated that the seller might dispose of its stock for cash within a short period of time. Thus, the argument that the steps should have been combined was stronger than in *King*.

As in *King*, the doctrine was applied at the behest of the party who did not take the steps that were combined. However, as noted in the discussion of *King*,<sup>225</sup> there

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217. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 522 (7th Cir. 1982).

218. The stock received by the sellers was unregistered and therefore resale was restricted by the Securities and Exchange Commission. The agreement included the registration of the sellers' shares in conjunction with the next new issue of McDonald's stock. *Id.*

219. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 522–23 (7th Cir. 1982).

220. *Id.* at 524.

221. *Id.* at 524–25.

222. See *infra* text accompanying notes 226–29.

223. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 524–25 (7th Cir. 1982).

224. See *supra* text accompanying notes 208–14.

225. *Id.*

is nothing to prevent the IRS from taking this weapon out of taxpayers' hands and using it against them in future cases.

#### D. *The Three Tests*

##### 1. *Background*

The three alternative approaches used in ascertaining whether the step transaction doctrine should apply are the "end result" test, the "interdependence" test, and the "binding commitment" test.<sup>226</sup>

Under the "end result" test, the purportedly separate steps will be combined if it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the final result. The "interdependence" test will combine the various steps in a transaction if they are found to be interdependent.<sup>227</sup> The "binding commitment" test only combines the steps of a transaction if the parties are contractually bound to move from one step to the next.<sup>228</sup> The restrictiveness of the "binding commitment" test has been regarded as too limited for general application of the step transaction doctrine, and may now apply only to distributions under section 355.<sup>229</sup>

##### 2. *Use of the Doctrine by Taxpayers*

*King* and *McDonald's* raise several policy questions and present planning opportunities for practitioners. The cases confirm that taxpayers, as well as the IRS, may invoke the step transaction doctrine. These cases are, however, not the first cases in which taxpayers have successfully invoked the step transaction or related doctrines.<sup>230</sup>

An older, contrary line of cases holds that while the government may penetrate the form of a transaction to reach its substance, the taxpayer must abide by the form he chose.<sup>231</sup> As a policy matter, taxpayers should not be able to deny *post facto* the form they chose in conducting the transaction and use the substance over form argument to their advantage. Perhaps Judge Learned Hand said it best: "[T]he Treasury may take a taxpayer at his word . . . when that serves its purpose . . . but that is a rule which works only in the Treasury's own favor; it cannot be used to deplete the revenue."<sup>232</sup>

226. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 524-25 (7th Cir. 1982). See also Mintz and Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX'N 247, 249-53 (1954).

227. See *supra* note 213. See also R. Paul and P. Zimet, *SELECTED STUDIES IN FEDERAL TAXATION*, 2d SERIES 200-54 (1938).

228. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 524-25 (7th Cir. 1982). See also *Commissioner v. Gordon*, 391 U.S. 83 (1968) (requirement that 80% or all of the stock of the subsidiary be distributed to qualify as a tax-free spin-off under 355 was not met by a distribution in separate steps separated by two years in the absence of a binding commitment to take the second step after the first step).

229. *King Enters., Inc. v. United States* 418 F.2d 511, 521 (Ct. Cl. 1969).

230. See, e.g., *Weiss v. Steam*, 265 U.S. 242 (1924); *Bartels v. Birmingham*, 332 U.S. 126 (1947); *Shaw v. Commissioner*, 59 T.C. 375 (1972). Cf. Rev. Rul. 55-540, 1955-2 C.B. 39 (standards for treating leases as sales appear to be available to either IRS or taxpayers).

231. See *Higgins v. Smith*, 308 U.S. 473 (1940) (loss on selling depreciated securities to wholly-owned corporation not deductible); *United States v. Morris & Essex R.R.*, 135 F.2d 711 (2d Cir.), cert. denied, 320 U.S. 754 (1943).

232. *United States v. Morris & Essex R.R.*, 135 F.2d 711, 713 (2d Cir.), cert. denied, 320 U.S. 754 (1943).

Practitioners may be expected to use these cases as a way to avoid reorganization treatment. The technique would be to use a post-reorganization disposition of stock for cash as an integrated step in the transaction.<sup>233</sup>

### 3. Time Between Steps

Also raised is the issue of the relationships of the time between the steps taken and the likelihood that the doctrine will be applied. *King* and *McDonald's* raise serious policy questions with respect to the amount of time that must elapse between the steps of a transaction, to avoid application of the step transaction doctrine.

Although the courts in *King* and *McDonald's* never stated explicitly, it appears that the time between the steps taken is the dominant factor in determining whether the steps will be combined. For example, in *King*, only a few months elapsed between the agreement by King and the other shareholders to sell their Tenco stock to Minute Maid and the liquidation of Tenco by Minute Maid.<sup>234</sup> In *McDonald's*, the steps were separated by six months.<sup>235</sup> If the steps in these cases had been separated by substantially more time, it is less likely that the courts would have concluded that the steps should be combined under the "end result" or "interdependence" tests.

As a planning matter for practitioners, lengthening the time between steps in a transaction to avoid application of the step transaction doctrine has dubious value. It may be easy to speculate that two steps should be separated by ten years in order to avoid application of the step transaction doctrine, but the parties involved usually cannot wait that long.

As a policy matter the question is: How long a time period must elapse between steps to preclude application of the doctrine? As a matter of the administration of the tax laws, there should be clear standards as to when an important doctrine such as the step transaction doctrine would apply. One virtue of the continuity of interest doctrine<sup>236</sup> is the clear standard for ascertaining when it will apply.<sup>237</sup> Unfortunately, there are no clear standards on the length of time that must elapse between steps to immunize a transaction against application of the step transaction doctrine.

In Revenue Ruling 66-23,<sup>238</sup> the IRS ruled that holding stock for five years after a reorganization is sufficient to establish post-reorganization continuity of interest for purposes of the continuity of interest doctrine. This ruling dealt with a specialized case in which the taxpayer, for antitrust reasons, was under a court order to dispose of stock he received in a merger within seven years.

The IRS also ruled in Revenue Ruling 78-142<sup>239</sup> that mandatory serial redemptions of stock received in a reorganization did not violate continuity of interest because such redemptions would not commence until five years after the reorganization.

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233. The main reasons for avoiding reorganization treatment would be to obtain stepped-up basis for the assets acquired or to recognize a loss. See I.R.C. §§ 362, 354 (1986).

234. *King Enters., Inc. v. United States*, 418 F.2d 511, 514 (Ct. Cl. 1969).

235. *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 522 (7th Cir. 1982).

236. See *supra* notes 37-46 and accompanying text.

237. *Id.*

238. Rev. Rul. 66-23, 1966-1 C.B. 67, 68.

239. Rev. Rul. 78-142, 1978-1 C.B. 111, citing Rev. Rul. 66-23.

These rulings dealt with the application of the step transaction doctrine to the continuity of interest area. The lack of standards in the step transaction area undermines the otherwise relatively clear standards in the continuity of interest area.

These rulings suggest that five years between steps is a safe-harbor for immunization against application of the step transaction doctrine. This interpretation does not provide much comfort for practitioners, since five years is a long time to wait before an attractive further step can be taken. However, Revenue Ruling 66-23 stated that even if the taxpayer under the antitrust court order disposed of some or all of his stock within five years, the status of the reorganization would not be lost absent a "preconceived plan or arrangement" to sell the shares.<sup>240</sup> This Ruling takes us right back to the beginning.

Does a "preconceived plan or arrangement" mean a binding commitment?<sup>241</sup> Something less than a binding commitment, such as an overall plan from the beginning, would probably cause the doctrine to be invoked if steps were taken within five years of each other. Revenue Ruling 66-23 implies that a preconceived plan or arrangement (or certainly a binding commitment) that encompassed steps to be taken separated by more than five years could cause the doctrine to be invoked.

Also, what of the case in which the second step was taken within three weeks of the first step, but there was absolutely no intention or contemplation by the parties involved of taking the second step when the transaction was commenced. However, suppose external business conditions changed dramatically during the three week period, suddenly causing the second step to become imperative. Presumably, if these facts could be shown, the step transaction doctrine would not be applied even though the parties obtain tax advantages from treating the steps independently. Thus, tax benefits derived accidentally are all right, but tax benefits that are planned for may be disallowed.

Speculations such as these demonstrate the frustrating nature of the step transaction doctrine. Avoidance of the step transaction doctrine requires that the underlying facts show the independent business significance and usefulness of each individual step.<sup>242</sup> There is also a strong implication that time is a factor. Absent a binding commitment, the longer the time between the steps the less likely it is the doctrine will be applied.

One might draw from this discussion a crude, negative conclusion: Any transaction that is superficial, that bestows great tax advantages by touching all the statutory bases, but whose steps do not have independent non-tax significance, and which is accomplished over a relatively short period of time, is vulnerable to application of the doctrine. Such a vague, qualified test is grossly inadequate for dealing with the sophisticated reorganization transactions to which it will be applied.

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240. Rev. Rul. 66-23, 1966-1 C.B. 67, 68.

241. See *supra* text accompanying notes 226-28.

242. See *supra* text accompanying notes 218-21. Cf. *Manhattan Bldg. Co. v. Commissioner*, 27 T.C. 1032, 1042 (1957) ("The test is, were the steps taken so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series.").

#### 4. A Proposed Safe-Harbor Time Period

It would be helpful if the IRS would promulgate a revenue ruling concerning the safe-harbor time period which must elapse between steps. The ruling should provide that if the steps taken are separated by more than the safe-harbor time period, the IRS will not apply the step transaction doctrine, unless the parties have a binding (legally enforceable) commitment to take the further steps.

There is ample precedent in the statute for specific time periods governing the treatment of particular transactions.<sup>243</sup> What is proposed here is broader—a time period governing a judicial doctrine that covers a wide range of transactions under the Internal Revenue Code. The use of time periods for other transactions suggests this approach can work for a broad doctrine like the step transaction doctrine.

This Article is less concerned about the length of the time period than that there be a safe-harbor time period so all parties—taxpayers, the courts, the IRS, and tax advisors—could be spared the interminable litigation and uncertainty that attends the present state of the law in this important area.

### IX. PROPOSALS FOR SIMPLIFICATION AND REFORM

#### A. The Subchapter C Revision Act

The law of what constitutes a Type A reorganization is quite complex. Moreover, the previous discussion concerning the standards for qualifying as a Type A reorganization applies to the other forms of reorganizations.<sup>244</sup> Not surprisingly, there has been a strong effort to attempt to reform and simplify this area as part of a general reform and simplification of the entire field of corporate taxation.<sup>245</sup>

Substantial work has been done in this area by the American Law Institute, the Tax Section of the American Bar Association, the Federal Tax Division of the American Institute of Certified Public Accountants, and the Tax Section of the New York State Bar Association.<sup>246</sup> Much of this work has been embodied in the Subchapter C Revision Act of 1985, developed by the Staff of the Senate Finance Committee and currently pending before Congress.<sup>247</sup>

These proposals will remain the focus of attention because the legislative history of the Tax Reform Act of 1986 directs the Treasury Department to determine whether changes in the provisions of subchapter C are desirable and requires that the Treasury report to Congress no later than January 1, 1988.<sup>248</sup>

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243. See, e.g., I.R.C. §§ 338(a), 338(d)(3) (1986) (benefits of a step-up in the basis of assets of an acquired subsidiary under § 338 only available if 80% of the stock of the subsidiary was acquired within a 12 month period); I.R.C. § 333 (1986) (gain to the shareholders on liquidation of a corporation may be deferred if the transaction meets certain requirements and the liquidation takes place within one calendar month).

244. See *supra* notes 10–17 and accompanying text.

245. See *supra* note 2.

246. *Id.*

247. FINAL REPORT, *supra* note 2. See also Faber and LeDuc, *Acquisitions Proposals and Their Effect on Corporations, Shareholders and Creditors: Reform of Reorganizations and Liquidations*, 22 SAN DIEGO L. REV. 3 (1985); Thompson and Ginsberg, *A Comparison of the Merger and Acquisition Provisions of Present Law with the Provisions in the Senate Finance Committee's Draft Bill*, 22 SAN DIEGO L. REV. 157 (1985).

248. FINAL REPORT, *supra* note 2, at 11–207.

The proposals in the Subchapter C Revision Act of 1985 concerning the Type A reorganization are part of larger proposals dealing with acquisitive corporate reorganizations. The overall philosophy of the proposals for acquisitive reorganizations is to create a system of explicit electivity instead of the transactional electivity that governs the present system.<sup>249</sup> Under the present system, if the taxpayers want a taxable merger, they can structure the transaction to achieve that result. Thus, they could give enough cash to break continuity of interest,<sup>250</sup> or they could ensure that continuity of the business enterprise is broken.<sup>251</sup> Under the new proposals, the choice of taxability or not is simply a matter of checking off a box on a form.<sup>252</sup>

To achieve this goal of explicit electivity, the Subchapter C Revision Act of 1985 contemplates a two step procedure.<sup>253</sup> First, there must be a qualified acquisition, either a qualified stock acquisition or a qualified asset acquisition.<sup>254</sup> A statutory merger or consolidation could constitute a "qualified asset acquisition" under the new proposals.<sup>255</sup> Once a "qualified asset acquisition" has occurred, the transaction is treated as a "carryover basis acquisition" unless an election for a "cost basis acquisition" is made.<sup>256</sup>

A carryover basis acquisition results in no gain being recognized by the target corporation,<sup>257</sup> and the acquiring corporation assuming the target corporation's basis in the assets acquired.<sup>258</sup> These are the same results that flow from mergers which qualify as a Type A reorganization under present law.<sup>259</sup>

Instead of allowing the transaction to proceed as a "carryover basis acquisition," a "cost basis acquisition" may be elected.<sup>260</sup> This election would result in the

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249. See *supra* notes 37-48 and accompanying text.

250. See *supra* notes 86-115 and accompanying text.

251. FINAL REPORT, *supra* note 2, at 51.

252. *Id.* at 50-58, 211-35, 237-39.

253. *Id.* at 112.

254. *Id.* at 113. The other transaction that would constitute a qualified asset acquisition is a transaction in which one corporation acquires at least 70% of the gross fair market value and at least 90% of the net fair market value of the assets of another corporation, and the target corporation distributes, within 12 months of the acquisition date, all of its remaining assets (other than assets retained to meet claims of creditors) to its shareholders or creditors. *Id.* at 113.

A qualified stock acquisition is any transaction or series of transactions during a 12 month acquisition period in which the corporation acquires stock representing control of another corporation. *Id.* at 112-13. This transaction approximates a Type B reorganization under present law, with addition of the 12 month time period. I.R.C. § 368(a)(1)(B) (1986). Cf. I.R.C. § 368(a)(2)(E)(ii) (1986) (requiring a 12 month acquisition period for stock of the target corporation in a reverse triangular A reorganization which, because the target corporation remains alive as a subsidiary of the acquiring corporation after the transaction, resembles the Type B reorganization). See B. Bittker, and J. Eustice, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* Ch. 14, 60-66 (1979).

255. FINAL REPORT, *supra* note 2, at 117.

256. *Id.* at 106.

257. *Id.* at 110.

258. I.R.C. §§ 361, 362 (1986).

259. FINAL REPORT, *supra* note 2, at 117.

260. *Id.* at 222-23. See also § 1012 (providing for a cost basis on acquired assets in the absence of any other basis rule applying). I.R.C. § 1012 (1986).

Treatment of the shareholders of the target corporation under the new proposals would be determined independently of the treatment of the corporation. Shareholders of the target corporation would be accorded nonrecognition of gain if they received stock of the acquiring corporation. If they received debt securities of the acquiring corporation, they would only be entitled to nonrecognition to the extent that the issue price of the debt securities received does not exceed the basis of the debt securities surrendered. This treatment is approximately the same as the treatment of the shareholders of the target corporation under present law, except the new proposals focus on the basis of the securities surrendered and the issue price of the securities received, rather than their principal amount. FINAL REPORT, *supra* note 2, at 44.



target corporation being taxed on the transaction and the acquiring corporation obtaining a cost (generally stepped-up) basis in the assets it acquires.<sup>261</sup>

## B. Critique

The discussion throughout this Article demonstrates that the present definition of a Type A reorganization is ascertained by reference to an amalgam of legislative, judicial, and administrative rules which, taken together, defy rationality. It seems safe to opine that no sane, rational individual attempting to ascertain when a merger might or might not be taxable would conjure up the legal scheme presently in force. However, much of the complexity and irrationality of the system arises from the fact that no one person or institution writes the tax laws. The complexity of the tax laws arises from the interaction of several sources of law, with the result that the transactions to be covered, particularly corporate combinations, are themselves quite complicated. Thus, proposals to rewrite the law to effect a substantial simplification may be viewed with a certain skepticism *ab initio*. The complex law of reorganizations is a symptom of the problem, not the problem itself. Therefore, rewriting the law to make it simpler might be likened to painting over spots on the skin in order to treat an attack of measles.

The underlying obstacles to major simplification of the law in this area manifest themselves in several ways in these proposals. For example, although one of the goals of the Subchapter C Revision Act is to move the system from transaction electivity to explicit electivity,<sup>262</sup> these proposals actually move from a system in which there is only transactional electivity to a system in which there is both transactional electivity and explicit electivity. This result does not foster simplicity.

The reason for this unsettling result is that under these proposals taxpayers may engage only in an explicit election of whether they will be taxed if their transaction constitutes a qualified acquisition.<sup>263</sup> However, certain specific requirements must be met for the transaction to constitute a qualified acquisition.<sup>264</sup> Taxpayers may or may not choose to meet these requirements. If they choose not to meet the requirements, they are not in the elective system.<sup>265</sup> Under the new proposals nonrecognition can be achieved only by electing it after there has been a qualified acquisition.<sup>266</sup> Therefore, deliberately failing to have a qualified acquisition results in a taxable transaction for the target and its shareholders.<sup>267</sup>

Thus, if the Subchapter C Revision Act is enacted, there would be two ways to have a taxable transaction to the target corporation. One would be to fail to engage

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261. FINAL REPORT, *supra* note 2, at 41.

262. See *supra* notes 244-61 and accompanying text.

263. *Id.*

264. Taxpayers interested in engaging in a merger who wish to avoid having a qualified acquisition could structure the transaction as an acquisition of assets of the target corporation rather than a statutory merger. In undertaking an acquisition of assets, they would be careful to acquire less than 70% of the gross fair market value or less than 90% of the net fair market value of the assets of the target corporation, so as to insure they would fail to have a qualified acquisition. See *supra* notes 244-61 and accompanying text.

265. FINAL REPORT, *supra* note 2, at 117.

266. Section 1001(c) provides that in the absence of an applicable nonrecognition provision, the entire amount of a realized gain or loss will be recognized. I.R.C. § 1001(c) (1986).

267. See *supra* notes 244-69 and accompanying text.

in a qualified acquisition (transaction electivity). The second would be to engage in a qualified acquisition but to elect cost basis treatment (explicit electivity). Again, this is not the path to simplification.

In defense of the Subchapter C Revision Act, the consequences to the shareholders of the target would be different in these two cases. When the transaction is taxable to the target corporation because the parties failed to engage in a qualified acquisition, the transaction would also be taxable to the target shareholders, regardless of the consideration received.<sup>268</sup> When the transaction is taxable to the target because a qualified acquisition was engaged in and a cost basis was elected, the transaction may not be taxable to the target shareholders depending on the consideration they receive. In particular, shareholders of the target corporation would be accorded nonrecognition of gain if they receive stock of the acquiring corporation in exchange for stock of the target.<sup>269</sup>

This difference, however, is less significant than might appear. There is nothing impressive from a policy standpoint with the idea that stockholders of a target corporation should not be taxed on the transaction if they receive stock of the acquiring corporation in exchange for stock in the target, but they will be taxed if they receive cash, notes, or other property. This result under the Subchapter C Revision Act is simply a perpetuation of the illogical continuity of interest doctrine.<sup>270</sup>

Beyond these basic problems with the Subchapter C Revision Act, it is not a monument to simplicity. The proposed new statutory language encompasses some 130 double-spaced pages.<sup>271</sup> Nowhere in the Final Report of the Senate Finance Committee Staff is it represented that there is any significant revenue impact as a result of these proposals. Indeed, the effective rate of tax on corporations can be manipulated without resort to such massive proposals through techniques such as simply raising the statutory rate of tax on corporations, moderating the attractive accelerated cost recovery system for depreciation,<sup>272</sup> and repealing the investment tax credit.<sup>273</sup> The latter two provisions were enacted by the Tax Reform Act of 1986.<sup>274</sup>

Thus, these proposals simply constitute one new complex system of corporate tax being substituted for another. From this perspective, there is little to recommend them. At least the present system is generally known and understood by practitioners. Moreover, as this Article has indicated, complexity in the area of corporate taxation and federal income taxation in general is inevitable, given the complexity of the transactions to be covered and the several institutional sources of tax law.

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268. *Id.* If the security holders of the target receive debt securities of the acquiring corporation, they would only be entitled to nonrecognition to the extent that the issue price of the debt securities received does not exceed the basis of the debt securities surrendered. FINAL REPORT, *supra* note 2, at 52.

269. See *supra* notes 37-46 and accompanying text.

270. FINAL REPORT, *supra* note 2, at 79-208.

271. *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, *supra* note 2, at 117-278.

272. I.R.C. § 168 (1986).

273. I.R.C. § 46 (1986).

274. CONFERENCE REPORT, *supra* note 4, at II 198- II 200.

## X. CONCLUSION

As this Article demonstrates, the corporate tax is inevitably going to be complex. Attempts to simplify or reform it will simply lead to a new complex system being substituted for the old. Whatever the merits of the proposals of the Senate Finance Committee, the American Law Institute and the other professional organizations concerned with reform, they have not created a simple new corporate tax. If the work of the outstanding individuals involved in these proposals could not yield a simple corporate tax, it cannot be done. There cannot be a simple corporate tax in the American tax system. It is time for those working in the field (including the author) to get up from the daisies, free ourselves from our complicated states of mind, and face the fundamental policy question in corporate taxation: Shall we continue to have a complicated corporate tax or shall we abolish it?

